

In the opinion of Bond Counsel to the State as described herein, under existing statutes and court decisions and assuming continuing compliance with certain tax covenants, interest on the Offered Veterans G.O. Bonds is not included in gross income for Federal income tax purposes pursuant to Section 103 of the Internal Revenue Code of 1986, as amended (the "Code") and (i) interest on the Series CF Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations; (ii) interest on the Series CG Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code and is not included in the adjusted current earnings of corporations for purposes of calculating the alternative minimum tax; and (iii) interest on the Series CH Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Code. Interest on the Offered Veterans G.O. Bonds is exempt from State of California personal income taxes. See "TAX MATTERS" herein.

\$118,710,000**STATE OF CALIFORNIA****VETERANS GENERAL OBLIGATION BONDS****\$82,725,000****Series CF (Non-AMT)****\$25,000,000****Series CG (Non-AMT)[†]****\$10,985,000****Series CH (AMT)****Dated: Date of Delivery****Due: As shown on the inside cover page**

This offering consists of veterans general obligation bonds listed above (the "Offered Veterans G.O. Bonds") authorized by the voters of the State of California (the "State"). The Offered Veterans G.O. Bonds will mature in the years and bear interest at the rates set forth on the inside cover page hereof.

Interest is payable on June 1 and December 1 of each year, commencing December 1, 2010. The Offered Veterans G.O. Bonds may be purchased in book-entry form only, in the principal amount of \$5,000 or any integral multiples thereof. See APPENDIX C – "DTC AND THE BOOK-ENTRY SYSTEM." The Offered Veterans G.O. Bonds are subject to redemption prior to maturity, including redemption at par. See "THE OFFERED VETERANS G.O. BONDS – Redemption."

The Offered Veterans G.O. Bonds are general obligations of the State to which the full faith and credit of the State is pledged. Debt service on the Offered Veterans G.O. Bonds is payable first from moneys required under the California Military and Veterans Code to be deposited from the Veterans Farm and Home Building Fund of 1943 to the Veterans' Bond Payment Fund and second, to the extent that the moneys in the Veterans' Bond Payment Fund are insufficient to pay the amount of debt service then due, from the General Fund of the State Treasury (the "General Fund"). Principal of and interest on all State general obligation bonds, including the Offered Veterans G.O. Bonds to the extent that the moneys in the Veterans' Bond Payment Fund are insufficient to pay the amount of debt service then due, are payable from any moneys in the General Fund, subject only to the prior application of such moneys to the support of the public school system and public institutions of higher education. See "AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS."

This cover page contains certain information for quick reference only. It is not a summary of this issue. Investors are advised to read the entire Official Statement to obtain information essential to the making of an informed investment decision.

The Offered Veterans G.O. Bonds are offered when, as and if issued and received by the initial purchaser, subject to certain conditions, including the receipt of certain legal opinions of the Honorable Edmund G. Brown Jr., Attorney General of the State of California, and of Hawkins Delafield & Wood LLP, Bond Counsel to the State. In connection with the issuance of the Offered Veterans G.O. Bonds, Gardner, Underwood & Bacon LLC has served as Financial Advisor to the State, Quateman LLP has served as Disclosure Counsel to the State, and Orrick, Herrington & Sutcliffe LLP and Stradling Yocca Carlson & Rauth, a Professional Corporation, have served as Co-Disclosure Counsel to the State regarding Appendix A. The Offered Veterans G.O. Bonds will be available for delivery on or about June 29, 2010.

Honorable Bill Lockyer
Treasurer of the State of California

The Offered Veterans G.O. Bonds were sold at competitive bid on June 23, 2010.

Interest rates have been set by the successful bidder.

Dated: June 23, 2010

[†] Interest not included in adjusted current earnings of corporations for purposes of the alternative minimum tax. See "TAX MATTERS – Federal Tax Matters – Opinion of Bond Counsel to the State."

\$118,710,000
STATE OF CALIFORNIA
VETERANS GENERAL OBLIGATION BONDS

\$82,725,000
Series CF (Non-AMT)

MATURITIES, PRINCIPAL AMOUNTS, INTEREST RATES AND CUSIPS[†]

Maturity Date (December 1)	Principal Amount	Interest Rate	CUSIP [†]	Maturity Date (December 1)	Principal Amount	Interest Rate	CUSIP [†]
2011	\$ 10,805,000	0.700%	13063BFY3	2015	\$ 21,005,000	2.875%	13063BGC0
2012	1,400,000	1.300	13063BFZ0	2016	11,940,000	3.000	13063BGD8
2013	20,545,000	2.250	13063BGA4	2017	3,400,000	3.125	13063BGE6
2014	13,630,000	2.625	13063BGB2				

\$25,000,000
Series CG (Non-AMT^{††})

MATURITIES, PRINCIPAL AMOUNTS, INTEREST RATES AND CUSIPS[†]

Maturity Date (December 1)	Principal Amount	Interest Rate	CUSIP [†]	Maturity Date (December 1)	Principal Amount	Interest Rate	CUSIP [†]
2011	\$ 465,000	0.800%	13063BGF3	2015	\$ 1,790,000	2.950%	13063BGK2
2012	7,665,000	1.450	13063BGG1	2016	2,005,000	3.400	13063BGL0
2013	8,080,000	2.200	13063BGH9	2017	655,000	3.700	13063BGM8
2014	4,330,000	2.450	13063BGJ5	2018	10,000	3.900	13063BGN6

\$10,985,000
Series CH (AMT)

MATURITIES, PRINCIPAL AMOUNTS, INTEREST RATES AND CUSIPS[†]

Maturity Date (December 1)	Principal Amount	Interest Rate	CUSIP [†]	Maturity Date (December 1)	Principal Amount	Interest Rate	CUSIP [†]
2012	\$ 3,340,000	1.800%	13063BGP1	2014	\$ 1,800,000	3.000%	13063BGR7
2013	3,945,000	2.500	13063BGQ9	2015	1,900,000	3.200	13063BGS5

Price of all Offered Veterans G.O. Bonds: 100%

[†] Copyright 2010, American Bankers Association. CUSIP[®] is a registered trademark of the American Bankers Association. CUSIP data herein is provided by the CUSIP Service Bureau, operated by Standard & Poor's, a division of The McGraw-Hill Companies, Inc. This data is not intended to create a database and does not serve in any way as a substitute for the CUSIP Services Bureau. CUSIP numbers have been assigned by an independent company not affiliated with the State and are included solely for the convenience of the registered owners of the applicable Offered Veterans G.O. Bonds. The State is not responsible for the selection or uses of these CUSIP numbers, and no representation is made as to their correctness on the applicable Offered Veterans G.O. Bonds or as included herein. The CUSIP number for a specific maturity is subject to being changed after the issuance of the Offered Veterans G.O. Bonds as a result of various subsequent actions including, but not limited to, a refunding in whole or in part or as a result of the procurement of secondary market portfolio insurance or other similar enhancement by investors that is applicable to all or a portion of certain maturities of the Offered Veterans G.O. Bonds.

^{††} Interest not included in adjusted current earnings of corporations for purposes of the alternative minimum tax. See "TAX MATTERS – Federal Tax Matters – Opinion of Bond Counsel to the State."

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Copies of this Official Statement may be obtained from:

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OFFICIAL STATEMENT

\$118,710,000

STATE OF CALIFORNIA

VETERANS GENERAL OBLIGATION BONDS

\$82,725,000

Series CF (Non-AMT)

\$25,000,000

Series CG (Non-AMT[†])

\$10,985,000

Series CH (AMT)

INTRODUCTION

This Introduction contains only a brief summary of the terms of the State of California Veterans General Obligation Bonds Series CF (the “Series CF Bonds”); Veterans General Obligation Bonds Series CG (the “Series CG Bonds”); and Veterans General Obligation Bonds Series CH (the “Series CH Bonds,” and together with the Series CF Bonds and the Series CG Bonds the “Offered Veterans G.O. Bonds”) and a brief description of the Official Statement. A full review should be made of the entire Official Statement, including the Appendices and information incorporated by reference. Summaries of provisions of the Constitution and laws of the State of California (the “State”) or any other documents referred to in this Official Statement do not purport to be complete and such summaries are qualified in their entirety by references to the complete provisions.

Description of the Offered Veterans G.O. Bonds

The issuance of veterans general obligation bonds and commercial paper notes (“Veterans G.O. Bonds”) is authorized by Bond Acts (defined below) approved by the voters of the State and by resolutions of the Veterans’ Finance Committee of 1943 (the “Veterans’ Finance Committee”). The Offered Veterans G.O. Bonds are authorized by specific Bond Acts to finance, or to refinance obligations that were issued to provide funds for the financing, of contracts (“Contracts of Purchase”) for the purchase of homes and farms for California military veterans under the Farm and Home Purchase Program (the “Program”) of the Department of Veterans Affairs of the State (the “Department”). The Offered Veterans G.O. Bonds are being issued for the purpose of (i) refunding certain outstanding Veterans G.O. Bonds and (ii) financing new and existing Contracts of Purchase. See “THE OFFERED VETERANS G.O. BONDS – Purpose” and “—Identification and Authorization of the Offered Veterans G.O. Bonds.”

The Offered Veterans G.O. Bonds will be offered and sold pursuant to an official statement, copies of which may be obtained from the Department or the Treasurer of the State of California (the “State Treasurer”) (see “—Additional Information” below).

See EXHIBIT 2 to APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments” for information regarding the amount of money currently available and also expected to be made available to finance Contracts of Purchase following the issuance of the Offered Veterans G.O. Bonds.

[†] Interest not included in adjusted current earnings of corporations for purposes of the alternative minimum tax. See “TAX MATTERS – Federal Tax Matters – Opinion of Bond Counsel to the State.”

The Offered Veterans G.O. Bonds will be registered in the name of a nominee of The Depository Trust Company, New York, New York (“DTC”) which will act as securities depository for the Offered Veterans G.O. Bonds. Beneficial interests in the Offered Veterans G.O. Bonds may be purchased in book-entry form only, in denominations of \$5,000 or any integral multiple thereof. Principal and interest are payable as specified on the front cover page of this Official Statement. See APPENDIX C – “DTC AND THE BOOK-ENTRY SYSTEM.”

Security for and Sources of Payment for Veterans G.O. Bonds

The Offered Veterans G.O. Bonds are general obligations of the State to which the full faith and credit of the State is pledged. See “AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS – Security for and Payment of Veterans G.O. Bonds.” The Military and Veterans Code (the “Veterans Code”) requires that, with respect to Veterans G.O. Bonds, on the dates when funds are to be remitted to bondholders for the payment of debt service on such Veterans G.O. Bonds, there shall be transferred to a revolving special fund in the State Treasury (the “Veterans’ Bond Payment Fund”) to pay the debt service on such Veterans G.O. Bonds, all of the money in the Veterans Farm and Home Building Fund of 1943 (the “1943 Fund”) (but not in excess of the amount of debt service then due and payable). Debt service on the Offered Veterans G.O. Bonds is payable first from moneys required under the Veterans Code to be deposited from the 1943 Fund to the Veterans’ Bond Payment Fund and second, to the extent that the moneys in the Veterans’ Bond Payment Fund are insufficient to pay the amount of debt service then due, from the General Fund of the State Treasury (the “General Fund”). Principal of and interest on all State general obligation bonds, including the Offered Veterans G.O. Bonds to the extent that the moneys in the Veterans’ Bond Payment Fund are insufficient to pay the amount of debt service then due, are payable from any moneys in the General Fund, subject only to the prior application of such moneys to the support of the public school system and public institutions of higher education. See “AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS.” The Bond Acts authorizing the Offered Veterans G.O. Bonds provide that the State shall collect annually, in the same manner and at the same time as it collects other State revenues, a sum sufficient, in addition to the ordinary revenues of the State, to pay the principal of and interest on the Offered Veterans G.O. Bonds. See “AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS,” APPENDIX A – “THE STATE OF CALIFORNIA – STATE FINANCES – The General Fund” and “STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – General Obligation Bonds” and APPENDIX B – “THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND.”

Redemption

The Offered Veterans G.O. Bonds are not subject to optional redemption prior to their stated respective maturity dates. The Offered Veterans G.O. Bonds are subject to special redemption prior to maturity. See “THE OFFERED VETERANS G.O. BONDS – Redemption.”

Information Related to this Official Statement

The information set forth herein has been obtained from official sources which are believed to be reliable, but it is not guaranteed as to accuracy or completeness. The information and expressions of opinion herein are subject to change without notice, and neither delivery of this Official Statement nor any sale made hereunder or any future use of this Official Statement

shall, under any circumstances, create any implication that there has been no change in the affairs of the State or the Department since the date hereof.

All financial and other information presented or incorporated by reference in this Official Statement has been provided by, respectively, the State or the Department from its records, *except* for information expressly attributed to other sources. The presentation of information, including tables of receipts from taxes and other revenues, is intended to show recent historic information and is not intended to indicate future or continuing trends in the financial position or other affairs of, respectively, the State or the Department. No representation is made that past experience, as it might be shown by such financial and other information, will necessarily continue or be repeated in the future. However, certain statements included or incorporated by reference in this Official Statement do constitute “forward-looking statements.” Such statements are generally identifiable by the terminology used such as “plan,” “expect,” “estimate,” “budget” or similar words. The achievement of certain results or other expectations contained in such forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause actual results, performance or achievement described to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Any statements made in this Official Statement involving matters of opinion, projections or estimates, whether expressly stated or not, are set forth as such and not as representations of fact.

A wide variety of other information, including financial information, concerning the State is available from State agencies, State agency publications and State agency websites. Any such information that is inconsistent with the information set forth in this Official Statement should be disregarded. No such information is a part of or incorporated into this Official Statement, except as expressly noted. See “FINANCIAL STATEMENTS” and APPENDIX A – “THE STATE OF CALIFORNIA – FINANCIAL STATEMENTS.”

The information in APPENDIX C – “DTC AND THE BOOK-ENTRY SYSTEM” has been furnished by The Depository Trust Company and no representation is made by the State, the Department or the Financial Advisor as to the accuracy or completeness of such information.

No dealer, broker, salesperson or other person has been authorized by the State to give any information or to make any representations other than those contained herein and, if given or made, such other information or representations must not be relied upon as having been authorized by the State. This Official Statement is not to be construed as a contract with the purchasers of the Offered Veterans G.O. Bonds.

Tax Matters

In the opinion of Hawkins Delafield & Wood LLP, Bond Counsel to the State, under existing statutes and court decisions and assuming continuing compliance by the State and the Department with certain tax covenants described therein, interest on the Offered Veterans G.O. Bonds is excluded from gross income for Federal income tax purposes pursuant to Section 103 of the Internal Revenue Code of 1986, as amended (the “Federal Tax Code”), and such interest is exempt from personal income taxes of the State of California under present State law. In addition, (i) interest on the Series CF Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations; (ii) interest on the Series

CG Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code and is not included in the adjusted current earnings of corporations for purposes of calculating the alternative minimum tax; and (iii) interest on the Series CH Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Code. See “TAX MATTERS” below, APPENDIX E – “CERTAIN FEDERAL TAX CODE REQUIREMENTS” and APPENDIX G – “PROPOSED FORM OF LEGAL OPINION OF BOND COUNSEL TO THE STATE.”

Plan of Distribution

The Offered Veterans G.O. Bonds were sold at competitive bid on June 23, 2010. This Official Statement does not constitute an offer to sell or the solicitation of an offer to buy, nor shall there be any sale of the Offered Veterans G.O. Bonds by any person, in any jurisdiction in which it is unlawful for such person to make such an offer, solicitation or sale.

Continuing Disclosure

The State Treasurer will agree on behalf of the State to provide annually certain financial information and operating data relating to the State by not later than April 1 of each year in which any Offered Veterans G.O. Bonds are outstanding (the “Treasurer’s Annual Report”), commencing with the report for the 2009-10 fiscal year, and to provide notices of the occurrence of certain other enumerated events if material. The Secretary of the Department will agree to provide annually certain financial information and operating data relating to the Program by not later than April 1 of each year in which any Offered Veterans G.O. Bonds are outstanding (the “Department’s Annual Report”). The specific nature of the information to be contained in the Treasurer’s Annual Report and the Department’s Annual Report or the notices of material events and certain other terms of the continuing disclosure obligations are summarized in APPENDIX D – “SUMMARY OF CONTINUING DISCLOSURE CERTIFICATES.”

During the past five years, the State and the Department have not failed to comply, in all material respects, with any “previous undertakings,” as that term is used in Rule 15c2-12 promulgated under the Securities Exchange Act of 1934, as amended (the “SEC Rule”), relating to any Veterans G.O. Bonds for which the Department or the State was an “obligated person” within the meaning of the SEC Rule.

Additional Information

Questions regarding this Official Statement and the issuance of these securities may be addressed to the office of the Honorable Bill Lockyer, Treasurer of the State of California, Public Finance Division, P.O. Box 942809, Sacramento, California 94209-0001, telephone (800) 900-3873. Questions regarding the Program and this Official Statement may be addressed to the Bond Finance Division of the Department of Veterans Affairs, P.O. Box 942895, Sacramento, California 94295-0001, telephone (916) 503-8012.

STATE FINANCIAL PRESSURE

The State experienced a severe economic recession which began in the first quarter of 2008 and ended at some point in the second half of 2009. Personal income fell in the first three quarters of 2009 before increasing moderately in the fourth quarter of 2009. Taxable sales fell sharply in the first half of 2009 before increasing substantially in the fourth quarter of 2009 and

the first quarter of 2010. The State's unemployment rate increased from 5.9 percent in January 2008 to 12.4 percent in May 2010. The rate of increase has slowed in 2010.

In response to the most severe economic downturn in the United States since the Great Depression, in the budget plan for Fiscal Year 2009-10 adopted on February 20, 2009 as amended by the revisions enacted on July 28, 2009 together with other related budget legislation (the "Amended 2009 Budget Act"), the State implemented substantial spending reductions, program eliminations, revenue increases, and other solutions in order to close an estimated \$60 billion budget gap over the combined 2008-09 and 2009-10 fiscal years. The State adopted reforms in nearly every area of government to better contain costs in the future. The May Revision of the 2010-11 Governor's Budget released May 14, 2010 (the "2010-11 May Revision") includes further reductions to many programs. If these proposals are adopted, it would bring overall General Fund spending to a level well below what it was a decade ago in fiscal year 1998-99 adjusted for population and inflation growth. See APPENDIX A – "THE STATE OF CALIFORNIA – 2010-11 PROPOSED GOVERNOR'S BUDGET AND THE 2010-11 MAY REVISION."

The State is slowly emerging from the recession, but economic growth is modest and the level of unemployment is still very high. Consequently, baseline General Fund revenues in fiscal year 2009-10 (consisting of total revenues adjusted to remove temporary tax law changes and one-time receipts) are projected to fall by more than 20 percent from their peak in fiscal year 2007-08. Major components of the revenue decline are capital gains taxes (\$8 billion below peak levels), income tax on wages (about \$6 billion below peak levels), tax on other types of income (\$7 billion below peak levels), sales taxes (\$10 billion below peak levels), corporate taxes (\$2 billion below peak levels), and all other taxes (about \$1 billion below peak levels). Consumer spending driven by easy credit and growth in home values is also not likely to return to prior levels in the foreseeable future. Future revenues will also be affected by the expiration of temporary tax increases enacted in fiscal year 2009-10.

In January 2010, California's projected budget gap for fiscal years 2009-10 and 2010-11 was \$19.9 billion. The deterioration of the State's fiscal condition since adoption of the Amended 2009 Budget Act was due to a combination of lower than projected revenues, failure to achieve expected savings (due in part to adverse court decisions) and population and caseload growth. A Special Session of the Legislature in February 2010 enacted several bills which addressed about \$2.1 billion of this gap. Further reduced revenue estimates (\$0.6 billion) and higher expenditure estimates (\$0.7 billion) added about \$1.3 billion to the gap, so that the 2010-11 May Revision now projects the remaining budget gap at \$19.1 billion. This figure is comprised of a current year shortfall of \$7.7 billion, a fiscal year 2010-11 shortfall of \$10.2 billion and a \$1.2 billion reserve for fiscal year 2010-11.

The 2010-11 May Revision proposes additional solutions to close the remaining budget gap. Additional federal funds (over and above the \$2.2 billion already approved) account for \$3.4 billion in solutions, a reduction from the \$6.9 billion of additional federal funds contained in the Governor's Proposed Budget for the 2010-11 Fiscal Year released on January 8, 2010 (the "2010-11 Governor's Budget"). Spending reductions account for \$12.4 billion in solutions. Additional solutions include \$1.3 billion in alternative funding and \$2.1 billion in fund shifts and other revenues. See APPENDIX A – "THE STATE OF CALIFORNIA – 2010-11 GOVERNOR'S BUDGET AND THE 2010-11 MAY REVISION" for a more detailed description of these proposals. In response, Legislative leaders have proposed two different

budget plans, one of which calls for significant tax increases, and another which would rely on a borrowing plan using certain significant non-General Fund revenues. All these proposals are now being considered by the Legislature. Even if all the Governor's proposals were to be adopted, the Administration still projects that there will be multi-billion dollar budget gaps in future years, as temporary fiscal measures adopted in recent years have to be repaid or temporary tax increases expire.

The sharp drop in revenues over the last two fiscal years also resulted in a significant depletion of cash resources to pay the State's obligations. For a period of one month, in February 2009, the State deferred making certain payments from the General Fund in order to conserve cash resources for high priority obligations, such as education and debt service. By July 2009, as new budget gaps were identified and with the failure to adopt corrective actions, the State's cash resources had dwindled so far that, commencing July 2, 2009, the State Controller began to issue registered warrants (or "IOUs") for certain lower priority obligations in lieu of warrants (checks), which could not be immediately cashed. The registered warrants, the issuance of which did not require the consent of the recipients thereof, bore interest. The registered warrants were all called for redemption on September 4, 2009 once the State was able to access the public credit markets for cash management purposes following enactment of the Amended 2009 Budget Act. No registered warrants were used to make high-priority payments, including debt service on bonds, payments to schools, or employee payrolls. The issuance of State registered warrants in 2009 was only the second time the State has issued State registered warrants since the 1930s.

The 2010-11 May Revision projects that the State will have sufficient cash resources to pay all of its obligations through the end of the current fiscal year, including repayment of all outstanding Revenue Anticipation Notes in June 2010 (a first maturity of \$2.825 billion was paid on May 25, 2010). Legislation enacted during the fiscal emergency special session in early March 2010 will provide the State with additional tools to manage cash in the summer of 2010 and during key months of the budget year by authorizing short-term deferral of certain State payments, primarily to schools and local governments. Proposals to close the budget shortfall will substantially reduce this cash gap. In addition to budget solutions, the State will need to obtain external financing early in the fiscal year. At the Governor's direction, the Department of Finance has begun working with the State Controller's Office and the State Treasurer's Office to develop additional cash solutions as needed to meet the State's payment obligations. See APPENDIX A – "THE STATE OF CALIFORNIA – CASH MANAGEMENT – Cash Management in Fiscal Year 2009-10" and "– Cash Management in Fiscal Year 2010-11"

The national and California economies improved between the 2010-11 Governor's Budget and the 2010-11 May Revision. Output of the national economy grew for the third consecutive quarter in the first quarter of 2010, and California payroll employment grew in four of the six consecutive months ending in March 2010. However, some sectors of both economies have yet to show any positive signs — construction being a prime example.

There are signs that home prices have begun to stabilize and have improved in many regions of the State. Existing home sales peaked during the summer of 2005 and fell steadily through November 2008. A robust recovery in sales took place between November 2008 and November 2009, as sales were boosted by the first-time homebuyers' tax credit. The tax credit was initially set to expire at the end of November 2009, but prior to its expiration, it was extended through April 30, 2010. Following the tax credit's extension, there was a moderate

rebound in sales in March 2010. The tax credit's expiration on April 30, 2010, coupled with severe winter weather, caused home sales to fall again.

The longest and deepest recession in the post-Depression era is most likely over. Both the State and national economies appear poised to make modest comebacks, and many indicators released since the 2010-11 Governor's Budget forecast have been more encouraging than originally expected. Still, the recovery will probably be moderate and prolonged by historical standards.

The pension funds managed by the State's principal retirement systems, the California Public Employees' Retirement System and the California State Teachers' Retirement System, have sustained significant investment losses during the economic downturn and currently have substantial unfunded liabilities which will require increased contributions from the General Fund in future years. The State also has an unfunded liability relating to retirees' post-employment healthcare benefits which was estimated to be \$51.8 billion as of June 30, 2009. See APPENDIX A – "THE STATE OF CALIFORNIA – STATE FINANCES – Pension Trusts."

These and other matters relating to the State's finances are set forth in greater detail in Appendix A which should be read in its entirety by purchasers of the Offered Veterans G.O. Bonds.

AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS

Authorization

The issuance of each series of Veterans G.O. Bonds is authorized by the related general obligation bond act identified under "THE OFFERED VETERANS G.O. BONDS – Identification and Authorization of the Offered Veterans G.O. Bonds" (collectively, the "Bond Acts") approved by the voters of the State and by resolutions of the Veterans' Finance Committee. The State General Obligation Bond Law (the "Law"), which is set forth in Chapter 4 (commencing with Section 16720) of Part 3 of Division 4 of Title 2 of the California Government Code as incorporated by reference into each Bond Act, provides for the authorization, sale, issuance, use of proceeds, repayment and refunding of State general obligation bonds, including Veterans G.O. Bonds. Each series of the Offered Veterans G.O. Bonds is authorized under the related Bond Act by one or more resolutions adopted by the Veterans' Finance Committee (collectively, the "Resolutions").

Currently, \$1,163,610,000 of new issue Veterans G.O. Bonds are authorized under Bond Acts but not issued; such amount does not include the aggregate principal amount of the Offered Veterans G.O. Bonds. See APPENDIX B – "THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND."

Security for and Payment of Veterans G.O. Bonds

Veterans G.O. Bonds are general obligations of the State. The Veterans Code establishes in the State Treasury the Veterans' Bond Payment Fund, a revolving special fund, and requires that on the dates when funds are to be remitted to bondholders for the payment of debt service on Veterans G.O. Bonds, there shall be transferred to the Veterans' Bond Payment Fund to pay the debt service on such Veterans G.O. Bonds all of the money in the 1943 Fund (but not in excess of the amount of debt service then due and payable). Debt service on Veterans G.O. Bonds is first payable from the moneys required under the Veterans Code to be deposited from the 1943 Fund to the Veterans' Bond Payment Fund and second, to the extent that the moneys in the

Veterans' Bond Payment Fund are insufficient to pay the amount of debt service then due, from the General Fund. Principal of and interest on all State general obligation bonds, including the Offered Veterans G.O. Bonds to the extent that the moneys in the Veterans' Bond Payment Fund are insufficient to pay the amount of debt service then due, are payable from any moneys in the General Fund of the State, subject only to the prior application of such moneys to the support of the public school system and public institutions of higher education.

Moneys in the Veterans' Bond Payment Fund are (i) required to be used solely to pay debt service when due with respect to Veterans G.O. Bonds, (ii) not considered "surplus money" for the purposes of the California Government Code and (iii) prohibited from being borrowed by, or transferred to, the General Fund or to the General Cash Revolving Fund.

The Bond Acts provide that the State shall collect annually, in the same manner and at the same time as it collects other State revenues, a sum sufficient, in addition to the ordinary revenues of the State, to pay principal of and interest on the Veterans G.O. Bonds. The Bond Acts also contain a continuing appropriation from the General Fund of the sum annually necessary to pay the principal of and the interest on the Veterans G.O. Bonds as they become due and payable. Under the State Constitution, the appropriation from the General Fund to pay the principal of and interest on Veterans G.O. Bonds as set forth in the related Bond Act cannot be repealed until the principal of and interest on such Veterans G.O. Bonds is paid and discharged. No further appropriation by the Legislature is required to pay the principal of and interest on Veterans G.O. Bonds.

The Bond Acts each provide that the Veterans G.O. Bonds issued thereunder constitute valid and legally binding general obligations of the State, and the full faith and credit of the State is pledged for the punctual payment of the principal of and interest thereon. The pledge of the full faith and credit of the State alone does not create a lien on any particular moneys in the General Fund or any other assets of the State, but is an undertaking by the State to be irrevocably obligated in good faith to use its taxing powers as may be required for the full and prompt payment of the principal of and interest on State general obligation bonds, including the Veterans G. O. Bonds to the extent that the moneys in the Veterans' Bond Payment Fund are insufficient to pay the amount of debt service then due, as the same becomes due. The only provision of the State Constitution that creates a higher priority for any State fiscal obligation is a provision directing that from all State revenues there will first be set apart the moneys to be applied by the State for the support of the public school system and public institutions of higher education. In the past when cash resources in the General Fund have been constrained, State officials have worked within their powers granted by State law to manage cash resources to ensure that payments to schools and universities and for general obligation debt service would be made. On any debt service date, all State general obligation bonds, including the Veterans G. O. Bonds, have an equal claim on moneys in the General Fund on that date for payment of debt service. See APPENDIX A – "THE STATE OF CALIFORNIA – STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – General Obligation Bonds."

The 1943 Fund

The Department's principal fund is the 1943 Fund. If the money transferred from the 1943 Fund to the Veterans' Bond Payment Fund on the remittance dates is less than the debt service then due and payable, the balance remaining unpaid is required to be transferred to the General Fund out of the 1943 Fund as soon as it becomes available, together with interest

thereon from the remittance date until paid, at the same rate of interest as borne by the applicable Veterans G.O. Bonds, compounded semiannually. See “– Security for and Payment of Veterans G.O. Bonds.” The 1943 Fund has always maintained moneys in an amount sufficient to make the required debt service payment to the General Fund. As of June 15, 2010, there were outstanding \$977,225,000 aggregate principal amount of Veterans G.O. Bonds, not including the Offered Veterans G.O. Bonds. The Veterans Code does not grant any lien on the 1943 Fund or the moneys therein to the holders of any Veterans G.O. Bonds.

The Department also issues Home Purchase Revenue Bonds (the “Revenue Bonds”) pursuant to the Veterans’ Revenue Debenture Act of 1970, as amended (the “Act”), a Resolution of Issuance for Department of Veterans Affairs of the State of California Home Purchase Revenue Bonds, adopted March 19, 1980, as amended and supplemented, and separate authorizing resolutions. Outstanding Revenue Bonds previously issued by the Department are and will be special obligations of the Department payable solely from, and secured by a pledge of, an undivided interest in the assets of the 1943 Fund (other than proceeds of Veterans G.O. Bonds or any amounts in any rebate account) and any reserve accounts established for the benefit of Revenue Bonds. The Veterans Code provides that this undivided interest in the 1943 Fund is secondary and subordinate to any interest or right in the assets of the 1943 Fund of the people of the State and of the holders of the Veterans G.O. Bonds (that is, the right to payment of debt service on Veterans G.O. Bonds described above). If the transfers required to be made to the Veterans’ Bond Payment Fund for debt service have been made, no holder or beneficial owner of Veterans G.O. Bonds has any right to restrict disbursements by the Department from the 1943 Fund for any lawful purpose, including payment of debt service on or redemptions and purchases of Revenue Bonds.

For additional information, see APPENDIX B – “THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE 1943 FUND”, EXHIBIT 1 to APPENDIX B – “FINANCIAL STATEMENTS OF THE 1943 FUND FOR FISCAL YEARS 2009 AND 2008 AND INDEPENDENT AUDITORS’ REPORT” and EXHIBIT 2 to APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Veterans G.O. Bonds and Revenue Bonds.”

Remedies

It is an event of default of the State under the Resolutions authorizing the Offered Veterans G.O. Bonds under the respective Bond Acts to fail to pay or to fail to cause to be paid, when due, or to declare a moratorium on the payment of, or to repudiate any Offered Veterans G.O. Bond.

Each Resolution states with regard to the Offered Veterans G.O. Bonds authorized by such Resolution that in the case that one or more events of default occurs, then and in every such case the registered Bondholder of the applicable Series is entitled to proceed to protect and enforce such registered Bondholder’s rights by such appropriate judicial proceeding as such registered Bondholder deems most effectual to protect and enforce any such right, whether by mandamus or other suit or proceeding at law or in equity, for the specific performance of any covenant or agreement contained in such Resolution, or in aid of the exercise of any power granted in such Resolution, or to enforce any other legal or equitable right vested in the Bondholders of the applicable Series by such Resolution or by law, as more specifically set forth in such Resolution authorizing the Offered Veterans G.O. Bonds pursuant to the respective Bond

Acts. Beneficial owners of the Bonds (the “Beneficial Owners”) cannot protect and enforce such rights except through the registered Bondholder. See “THE OFFERED VETERANS G.O. BONDS – General” and APPENDIX C – “DTC AND THE BOOK-ENTRY SYSTEM.”

Since the State has never failed to make a debt service payment on any general obligation bond, including any Veterans G.O. Bonds, when due, the exact steps which would be taken, or the remedies available to Bondholders, have never been tested. There are no cross-default provisions among general obligation bonds, including any Veterans G.O. Bonds, so any default with respect to any particular issue of bonds would not provide any remedy to holders of other bonds which are not affected. The State is not eligible to file for protection under the federal bankruptcy laws.

THE OFFERED VETERANS G.O. BONDS

General

The Offered Veterans G.O. Bonds will be registered in the name of the nominee of DTC, which will act as securities depository for the Offered Veterans G.O. Bonds. Beneficial interests in the Offered Veterans G.O. Bonds may be purchased in book-entry form only, in denominations of \$5,000 or any integral multiple thereof. See APPENDIX C – “DTC AND THE BOOK-ENTRY SYSTEM.”

Neither the State Treasurer nor the initial purchaser can or does give any assurances that DTC will distribute to Participants, or that Participants or others will distribute to the Beneficial Owners, payment of principal of and interest on the Offered Veterans G.O. Bonds paid or any redemption or other notices or that they will do so on a timely basis or will serve and act in the manner described in this Official Statement. Neither the State Treasurer nor the initial purchaser is responsible or liable for the failure of DTC or any Direct Participant or Indirect Participant to make any payments or give any notice to a Beneficial Owner with respect to the Offered Veterans G.O. Bonds or any error or delay relating thereto.

The Offered Veterans G.O. Bonds will be dated the Dated Date (as shown on the cover page hereof) and will mature on the respective dates and in the respective amounts set forth on the inside cover page hereof. Interest on the Offered Veterans G.O. Bonds will accrue from the Dated Date at the respective rates shown on the inside cover page of this Official Statement. Interest on the Offered Veterans G.O. Bonds is payable on June 1 and December 1 in each year (each, an “Interest Payment Date”) commencing December 1, 2010 and shall be calculated on the basis of a 360-day year comprised of twelve 30-day months.

Principal and interest are payable directly to DTC. Upon receipt of payments of principal and interest, it is the responsibility of DTC to in turn remit such principal and interest to the participants in DTC for disbursement to the beneficial owners of the Offered Veterans G.O. Bonds. The record date for the payment of interest on the Offered Veterans G.O. Bonds is the close of business on the 15th day of the month immediately preceding an Interest Payment Date, whether or not the record date falls on a business day.

Purpose

Under the Program, the Department acquires residential property to be sold to eligible veterans under Contracts of Purchase between the Department and such veterans. Such acquisition is financed principally with the proceeds of Veterans G.O. Bonds and the Department’s Revenue Bonds. The Offered Veterans G.O. Bonds are being issued for the

purpose of (i) refunding certain outstanding Veterans G.O. Bonds and (ii) financing new and existing Contracts of Purchase. See EXHIBIT 2 TO APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments” for information regarding the amount of money expected to be made available to finance Contracts of Purchase following the issuance of the Offered Veterans G.O. Bonds.

Identification and Authorization of the Offered Veterans G.O. Bonds

The Offered Veterans G.O. Bonds are issued under separate Bond Acts authorized by the voters of the State as described below. See APPENDIX A – “THE STATE OF CALIFORNIA – STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – General Obligation Bonds.”

Authorization

\$56,325,000 principal amount of Veterans General Obligation Bonds, Series CF, authorized under the Veterans Bond Act of 1986.

\$11,900,000 principal amount of Veterans General Obligation Bonds, Series CF, authorized under the Veterans Bond Act of 1988.

\$14,500,000 principal amount of Veterans General Obligation Bonds, Series CF, authorized under the Veterans Bond Act of 1996.

\$25,000,000 principal amount of Veterans General Obligation Bonds, Series CG, authorized under the Veterans Bond Act of 2000.

\$3,220,000 principal amount of Veterans General Obligation Bonds, Series CH, authorized under the Veterans Bond Act of 1986.

\$7,700,000 principal amount of Veterans General Obligation Bonds, Series CH, authorized under the Veterans Bond Act of 1988.

\$65,000 principal amount of Veterans General Obligation Bonds, Series CH, authorized under the Veterans Bond Act of 1990.

Redemption

No Optional Redemption

The Offered Veterans G.O. Bonds are not subject to optional redemption prior to their stated respective maturity dates.

Special Redemption from Excess Revenues

The Offered Veterans G.O. Bonds are subject to special redemption on any date prior to their respective stated maturity dates, at the option of the State upon request of the Department, from Excess Revenues (as defined below) derived from any Veterans G.O. Bonds or any Revenue Bonds. Any such redemption may be in whole or in part (and of any maturity of any Series at the option of the State upon request of the Department and by lot within such maturity), at the principal amount thereof plus accrued interest to the date fixed for redemption, without premium.

“Excess Revenues” means, as of any date of calculation, Revenues (as defined in Appendix B) in excess of Accrued Debt Service (as defined in Appendix B). Excess Revenues can include prepayments and repayments on Contracts of Purchase funded by Veterans G.O. Bonds and Revenue Bonds, investment earnings, certain insurance receipts and Revenues which had been set aside to be recycled into new Contracts of Purchase. All payments on Contracts of Purchase are deposited in the 1943 Fund and applied to pay debt service on the Veterans G.O. Bonds, Revenue Bonds, for mandatory redemptions of Veterans G.O. Bonds and Revenue Bonds, to pay Program and Department expenses, and to pay certain insurance claims. See “AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS – Security for and Payment of Veterans G.O. Bonds.” The Department, subject to applicable bond authorizing resolutions, may apply Excess Revenues to redeem any Veterans G.O. Bonds or Revenue Bonds eligible for redemption. The Department’s decision to apply Excess Revenues to redeem bonds, to finance Contracts of Purchase, or for any other permitted purpose depends on many factors, including but not limited to applicable bond authorizing resolution requirements, demand for Contracts of Purchase, debt service cost savings, investment earnings, and Federal Tax Code requirements. See EXHIBIT 2 to APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL AND OPERATING DATA – Contracts of Purchase – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments.” See APPENDIX B – “THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE 1943 FUND – Excess Revenues.”

The Department’s actual past prepayment experience for existing Contracts of Purchase is set forth in EXHIBIT 2 to APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Contracts of Purchase Origination and Principal Repayment Experience.”

For certain qualified mortgage bonds issued or to be issued after 1988, the Federal Tax Code prohibits repayments (including prepayments) of principal of Contracts of Purchase financed with the proceeds of an issue of such bonds to be used to make additional Contracts of Purchase after 10 years from the date of issuance of such bonds (or the date of issuance of original bonds in the case of refundings), after which date such amounts must be used to redeem such bonds of the issue, except for a \$250,000 *de minimis* amount. See “TAX MATTERS – Federal Tax Matters.”

The Federal Tax Code requires a payment to the United States from certain veterans whose Contracts of Purchase are originated after December 31, 1990 with the proceeds of qualified mortgage bonds. Since such requirement remains in effect with respect to any Contracts of Purchase originated after December 31, 1990 with proceeds of the applicable Revenue Bonds, for a period ending nine years after the execution of such Contracts of Purchase, the Department is unable to predict what effect, if any, such requirement will have on the origination or prepayment of Contracts of Purchase to which such provision applies.

Notice of Redemption

When redemption is required while the Offered Veterans G.O. Bonds are in book-entry form, the State Treasurer is to give notice of redemption by sending copies of such notice only to DTC (not to the beneficial owners of the Offered Veterans G.O. Bonds) not less than thirty or more than sixty days prior to the date fixed for redemption. DTC, in turn, is to send the notice of

redemption to its participants for distribution to the Beneficial Owners of the Offered Veterans G.O. Bonds. See APPENDIX C – “DTC AND THE BOOK-ENTRY SYSTEM.” The notice from the State Treasurer will state, among other things, that the Offered Veterans G.O. Bonds or a designated portion thereof (in the case of partial redemption of an Offered Veterans G.O. Bond) are to be redeemed, the dated date of the Offered Veterans G.O. Bonds, the redemption date, the Series and applicable maturity of the Offered Veterans G.O. Bonds to be redeemed and the redemption price. The notice will also state that after the date fixed for redemption, no further interest will accrue on the principal of any Offered Veterans G.O. Bonds called for redemption. Notice of redemption will also be provided to certain financial information services and securities depositories.

TAX MATTERS

Federal Tax Matters

The Offered Veterans G.O. Bonds are considered a single issue for Federal income tax purposes and the requirements of applicable Federal tax law must be satisfied with respect to each series of the Offered Veterans G.O. Bonds in order that interest on the Offered Veterans G.O. Bonds not be included in gross income for Federal income tax purposes retroactive to the date of issuance thereof. Proceeds of the Series CG Bonds will be used to finance new and existing Contracts of Purchase. Since the Series CF Bonds and Series CH Bonds are refunding bonds, proceeds of such Offered Veterans G.O. Bonds must be used to retire outstanding bonds within ninety days of their date of issuance. Failure to so use all of such proceeds and to comply with other requirements of the Federal Tax Code with respect to the Offered Veterans G.O. Bonds could cause interest on the Offered Veterans G.O. Bonds to be included in gross income for Federal income tax purposes retroactive to their date of issuance.

Requirements Imposed on the Offered Veterans G.O. Bonds by the Federal Tax Code

The Federal Tax Code contains the following loan eligibility requirements which are applicable (with certain exceptions), in whole or in part, to Contracts of Purchase (or portions of Contracts of Purchase) entered into with respect to properties acquired with amounts allocable to qualified veterans' mortgage bonds. The Offered Veterans G.O. Bonds are qualified veterans' mortgage bonds and not qualified mortgage bonds (as such term is defined in Appendix E). The moneys which will be made available from the issuance of the Offered Veterans G.O. Bonds to finance Contracts of Purchase will be QVMB Proceeds (as such term is defined in Appendix B). The loan eligibility requirements described in APPENDIX E – “CERTAIN FEDERAL TAX CODE REQUIREMENTS” do not apply to Pre-Ullman Moneys (as defined below) and APPENDIX B – THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE PROGRAM – Certain Statutory Requirements – Federal Tax Code.

The first general requirement of the Federal Tax Code which is applicable to qualified veterans' mortgage bonds is that the aggregate amount that may be issued must not exceed the volume limit based upon statutory formula. The Offered Veterans G.O. Bonds are in compliance with such requirement.

The Federal Tax Code requires that the effective interest rate on mortgage loans financed with the lendable proceeds of qualified veterans' mortgage bonds (such as the Offered Veterans G.O. Bonds) may not exceed the yield on the issue by more than 1.125% (see "Yield Limitations and Rebate" in Appendix E) and that certain investment earnings on non-mortgage investments, calculated based upon the extent such investment earnings exceed the amount that would have been earned on such investments if the investments were invested at a yield equal to the yield on the issue, be rebated to the United States or to veterans. The Department has covenanted to comply with these requirements and has established procedures to determine the amount of excess earnings, if any, that must be rebated to the United States or to veterans. See APPENDIX B – "THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE PROGRAM – Contracts of Purchase" for discussions of provisions of the Veterans Code which affect the Department's ability to establish and to change interest rates on Contracts of Purchase.

Opinion of Bond Counsel to the State

In the opinion of Bond Counsel to the State (expected to be delivered in substantially the form set forth with respect to the Offered Veterans G.O. Bonds in Appendix G), under existing statutes and court decisions and assuming continuing compliance with certain tax covenants described in such opinion, interest on the Offered Veterans G.O. Bonds is not included in gross income for Federal income tax purposes pursuant to Section 103 of the Code and (i) interest on the Series CF Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations; (ii) interest on the Series CG Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code and is not included in the adjusted current earnings of corporations for purposes of calculating the alternative minimum tax; and (iii) interest on the Series CH Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Code.

In rendering the foregoing opinions, Bond Counsel to the State has assumed compliance by the State and the Department with and enforcement by the State and the Department of the documents authorizing the issuance of the Offered Veterans G.O. Bonds and the Program Documents (as such term is defined in Appendix E).

In rendering its opinions, Bond Counsel to the State expresses no opinion regarding any other Federal or, except as stated below under "State Tax Matters," state tax consequences with respect to the Offered Veterans G.O. Bonds. Bond Counsel to the State renders its opinions under existing statutes and court decisions as of the issue date, and assumes no obligation to update its opinions after the issue date to reflect any future action, fact or circumstance, or any change in law or interpretation or otherwise. In rendering its opinions, Bond Counsel to the State expresses no opinion on the effect of any action taken or not taken after the date of the opinion in reliance upon an opinion of other counsel on the exclusion from gross income for Federal income tax purposes of interest on the Offered Veterans G.O. Bonds, or under state and local tax law.

Certain Collateral Federal Tax Consequences

The following is a brief discussion of certain collateral Federal income tax matters with respect to the Offered Veterans G.O. Bonds. It does not purport to address all aspects of Federal taxation that may be relevant to a particular owner of a Offered Veterans G.O. Bond. Prospective investors, particularly those who may be subject to special rules, are advised to consult their own tax advisors regarding the Federal tax consequences of owning and disposing of the Offered Veterans G.O. Bonds.

Prospective owners of Offered Veterans G.O. Bonds should be aware that the ownership of such obligations may result in collateral Federal income tax consequences to various categories of persons, such as corporations (including S corporations and foreign corporations), financial institutions, property and casualty and life insurance companies, individual recipients of Social Security and railroad retirement benefits, individuals otherwise eligible for the earned income tax credit, and taxpayers deemed to have incurred or continued indebtedness to purchase or carry obligations the interest on which is excluded from gross income for Federal income tax purposes. Interest on the Offered Veterans G.O. Bonds may be taken into account in determining the tax liability of foreign corporations subject to the branch profits tax imposed by Section 884 of the Code.

Information Reporting and Backup Withholding

Information reporting requirements will apply to interest paid on tax-exempt obligations, including the Offered Veterans G.O. Bonds. In general, information reporting requirements are satisfied if the interest recipient completes, and provides the payor with, a Form W-9, "Request for Taxpayer Identification Number and Certification," or unless the recipient is one of a limited class of exempt recipients, including corporations. A recipient not otherwise exempt from information reporting who fails to satisfy the information reporting requirements will be subject to "backup withholding," which means that the payor is required to deduct and withhold a tax from the interest payment, calculated in the manner set forth in the Code. For the foregoing purpose, a "payor" generally refers to the person or entity from whom a recipient receives its payments of interest or who collects such payments on behalf of the recipient.

If an owner purchasing a Offered Veterans G.O. Bond through a brokerage account has executed a Form W-9 in connection with the establishment of such account, as generally can be expected, no backup withholding should occur. In any event, backup withholding does not affect the excludability of the interest on the Offered Veterans G.O. Bonds from gross income for Federal income tax purposes. Any amounts withheld pursuant to backup withholding would be allowed as a refund or a credit against the owner's Federal income tax once the required information is furnished to the Internal Revenue Service.

State Tax Matters

In the opinion of Bond Counsel to the State to be rendered with respect to the Offered Veterans G.O. Bonds on the date of delivery thereof, interest on the Offered Veterans G.O. Bonds is exempt from personal income taxes of the State of California under State law in effect on the date of such opinion. A complete copy of the proposed form of opinion to be rendered with respect to the Offered Veterans G.O. Bonds is contained in Appendix G.

Miscellaneous

Tax legislation, administrative actions taken by tax authorities, or court decisions, whether at the Federal or state level, may adversely affect the tax-exempt status of interest on the Offered Veterans G.O. Bonds under Federal or state law and could affect the market price or marketability of the Offered Veterans G.O. Bonds. There can be no assurance that any such legislation, actions or decisions, if ever enacted, taken or rendered following the issuance of the Offered Veterans G.O. Bonds, will not have an adverse effect on the tax exempt status, market price or marketability of the Offered Veterans G.O. Bonds.

Prospective purchasers of the Offered Veterans G.O. Bonds should consult their own tax advisors regarding the foregoing matters.

LEGAL OPINIONS

The opinion of the Honorable Edmund G. Brown Jr., Attorney General of the State of California (the “Attorney General”), approving the validity of the Offered Veterans G.O. Bonds, will accompany the Offered Veterans G.O. Bonds deposited with DTC. The opinion of Bond Counsel to the State approving the validity of the Offered Veterans G.O. Bonds and addressing certain tax matters will also accompany the Offered Veterans G.O. Bonds deposited with DTC. The proposed forms of the legal opinions of the Attorney General and Bond Counsel to the State are set forth in Appendix F and Appendix G, respectively.

Certain legal matters will be passed upon by Quateman LLP, Disclosure Counsel to the State, and by Orrick, Herrington & Sutcliffe LLP and Stradling Yocca Carlson & Rauth, a Professional Corporation, Co-Disclosure Counsel to the State regarding Appendix A.

The Attorney General, Bond Counsel to the State, Disclosure Counsel to the State and Co-Disclosure Counsel to the State regarding Appendix A undertake no responsibility for the accuracy, completeness or fairness of this Official Statement.

LITIGATION

There is no litigation now pending (with service of process on the State or the Department having been accomplished) or threatened seeking to restrain or enjoin the sale, issuance, execution or delivery of the Offered Veterans G.O. Bonds or challenging the validity of the Offered Veterans G.O. Bonds or any proceedings of the State or of the Department taken with respect to the foregoing.

At any given time, including the present, there are numerous civil actions pending against the State (including, but not limited to, those discussed in Appendix A), that could, if determined adversely to the State, affect the State’s expenditures and, in some cases, its revenues and cash flow. While there can be no assurances as to the ultimate outcome and fiscal impact of such litigation, the State believes that it is unlikely that the outcome of any such litigation could materially adversely affect the State’s ability to pay principal of and interest on the Offered Veterans G.O. Bonds when due. See APPENDIX A – “THE STATE OF CALIFORNIA – LITIGATION.”

There may, from time to time, be litigation affecting the Department that does not directly relate to the Veterans G.O. Bonds which, nonetheless, may relate to the 1943 Fund.

FINANCIAL STATEMENTS

Audited Basic Financial Statements of the State (the “Financial Statements”) are available for the fiscal year ended June 30, 2009. The Financial Statements have been examined by the State Auditor to the extent indicated in her report. The Financial Statements have been filed with the Municipal Securities Rulemaking Board’s Electronic Municipal Market Access website, as part of the Official Statement for certain State of California Bonds sold in 2010, and are incorporated by reference into this Official Statement. The Financial Statements are also available through electronic means. No such information is incorporated into this Official statement, except as expressly noted. See APPENDIX A – “THE STATE OF CALIFORNIA – FINANCIAL STATEMENTS” for further information on how to obtain or view the Financial Statements. Certain unaudited financial information for the eleven months ended May 31, 2010 is included as an exhibit to Appendix A. See APPENDIX A – “THE STATE OF CALIFORNIA – FINANCIAL STATEMENTS.”

INDEPENDENT AUDITORS

The financial statements of the 1943 Fund as of and for the years ended June 30, 2009 and June 30, 2008, in Exhibit 1 to Appendix B to this Official Statement have been audited by Deloitte & Touche LLP, independent auditors, as stated in their report appearing therein.

RATINGS

The Offered Veterans G.O. Bonds have received ratings of “A1” by Moody’s Investor Service (“Moody’s”), “AA” by Standard and Poor’s, a Division of The McGraw-Hill Companies, Inc. (“S&P”), and “AA-” by Fitch Ratings (“Fitch”). An explanation of the significance and status of such credit ratings may be obtained from the rating agencies furnishing the same. There is no assurance that such ratings will continue for any given period of time or that they will not be revised or withdrawn entirely by any such rating agencies if, in their respective judgments, circumstances so warrant. Any revision or withdrawal of a credit rating could have an effect on the market prices and marketability of the Offered Veterans G.O. Bonds. The State cannot predict the timing or impact of future actions by the rating agencies.

FINANCIAL ADVISOR

Gardner, Underwood & Bacon LLC is serving as the financial advisor (the “Financial Advisor”) to the State in connection with the issuance of the Offered Veterans G.O. Bonds. The Financial Advisor has not been engaged, nor has it undertaken, to make an independent verification or assume responsibility for the accuracy, completeness, or fairness of the information contained in this Official Statement.

ADDITIONAL INFORMATION

The purpose of this Official Statement is to supply information to prospective buyers of the Offered Veterans G.O. Bonds. Quotations from and summaries and explanations of the Offered Veterans G.O. Bonds and of statutes or documents are brief summaries thereof which do not purport to be complete or definitive, and reference is made to such statutes or documents for full and complete statements of the contents thereof.

Any statements in this Official Statement involving estimates, forecasts or matters of opinion, whether or not expressly so stated, are intended as such and not as representations of fact. This Official Statement is not to be construed as a contract or agreement between the State and the purchasers or holders of any of the Offered Veterans G.O. Bonds.

Questions regarding this Official Statement and the issuance of these securities may be addressed to the Office of the Honorable Bill Lockyer, Treasurer of the State of California, 915 Capitol Mall, Room 110, Sacramento, California 95814, telephone (800) 900-3873.

Questions regarding the Program and this Official Statement may be addressed to the Bond Finance Division of the Department of Veterans Affairs, P.O. Box 942895, Sacramento, California 94295-0001, telephone (916) 503-8012.

STATE OF CALIFORNIA

BILL LOCKYER

Treasurer of the State of California

APPENDIX A

THE STATE OF CALIFORNIA



Honorable Bill Lockyer

Treasurer of the State of California

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INTRODUCTION TO THE STATE OF CALIFORNIA AND APPENDIX A

APPENDIX A is the part of the Official Statement that provides investors with information concerning the State of California. This Introduction is intended to give readers a very brief overview of the main topics covered in APPENDIX A. Investors are advised to read the entire Official Statement, including APPENDIX A, to obtain information essential to making an informed investment decision. See “ – Certain Defined Terms” at the end of this section for certain defined terms used in this APPENDIX A.

Current Financial Stress. In 2008 and most of 2009, the state experienced what was the most significant economic downturn since the Great Depression of the 1930s. Since then, the state’s economy has grown slowly. As a result of continuing weakness in the state economy, state tax revenues have declined precipitously, resulting in large budget gaps and cash shortfalls. Further information is set forth under “STATE FINANCIAL PRESSURE” and “2010-11 PROPOSED GOVERNOR’S BUDGET AND 2010-11 MAY REVISION.”

There can be no assurances that the fiscal stress and cash pressures currently facing the state will not continue or become more difficult, or that continuing declines in state tax receipts or other impacts of the current economic situation will not further materially adversely affect the financial condition of the state.

State Revenues and Expenditures. The state receives revenues from taxes, fees and other sources, the most significant of which are the personal income tax, sales and use tax and corporation tax (which collectively constitute more than 90 percent of total revenues and transfers). The state expends money on a variety of programs and services. Significant elements of state expenditures include education (both kindergarten through twelfth grade (“K-12”) and higher education), health and human services, correctional programs, transportation and debt service. For a discussion of the sources and uses of state funds, see “STATE FINANCES.”

The final enacted state budget for fiscal year 2009-10 was accomplished in two steps, which required actions to close an estimated budget gap of almost \$60 billion over two fiscal years. See “AMENDED 2009 BUDGET ACT.” The Amended 2009 Budget Act and related legislation addressing the state’s financial situation were based on a variety of assumptions, several of which did not materialize. The 2010-11 May Revision (as of May 14, 2010) now projects that General Fund revenues and transfers in fiscal year 2009-10 will be about \$86.5 billion, with expenditures of \$86.5 billion, compared to estimated revenues and expenditures as of July 2009 of \$89.5 billion and \$84.6 billion, respectively. The estimated General Fund reserve balance at June 30, 2010 (assuming adoption of all of the Governor’s proposals in the 2010-11 May Revision) is currently negative \$7.7 billion, compared to an estimated reserve of \$500 million when the Amended 2009 Budget Act was adopted and an estimated negative \$5.4 billion balance when the 2010-11 Governor’s Budget was released in January 2010. (The projected negative fund balance at the end of fiscal year 2009-10 will include a carry-over negative fund balance of \$5.9 billion from the end of fiscal year 2008-09.) See Table 5 – “2009-10 Estimated General Fund Budget Summary.”

In the 2010-11 May Revision, the Governor estimates a budget gap of approximately \$19.1 billion for the combined 2009-10 and 2010-11 fiscal years, and has proposed a variety of expenditure reductions, borrowing and other actions to bring the 2010-11 budget into balance, with an estimated year-end reserve of \$1.2 billion. See “2010-11 PROPOSED GOVERNOR’S BUDGET AND THE 2010-11 MAY REVISION.”

General Fund. The moneys of the state are segregated into the General Fund and over 1,000 other funds, including special, bond and trust funds. The General Fund consists of revenues received by the State Treasury and not required by law to be credited to any other fund, as well as earnings from the

investment of state moneys not allocable to another fund. The General Fund is the principal operating fund for the majority of governmental activities and is the depository of most of the major tax revenue sources of the state. For additional financial data relating to the General Fund, see the financial statements incorporated in or attached to this APPENDIX A. See “STATE FINANCES” and “FINANCIAL STATEMENTS.”

State Budget. The State Constitution specifies that an annual budget shall be proposed by the Governor by January 10 of each year for the next fiscal year (the “Governor’s Budget”). Under state law, the annual proposed Governor’s Budget cannot provide for projected expenditures in excess of projected revenues for the ensuing fiscal year. State law also requires the Governor to update the Governor’s Budget projections and budgetary proposals by May 14 of each year (the “May Revision”). The May Revision is normally the basis for final negotiations between the Governor and Legislature to reach agreement on appropriations and other legislation to fund state government for the ensuing fiscal year (the “Budget Act”). The Budget Act must be approved by a two-thirds majority vote of each House of the Legislature, and must be in balance.

Over the years, a number of laws and constitutional amendments have been enacted, often through voter initiatives, which have made it more difficult for the state to raise taxes, restricted the use of the General Fund or special fund revenues, or otherwise limited the Legislature and the Governor’s discretion in enacting budgets. See “THE BUDGET PROCESS – Constraints on the Budget Process.”

The budget process and constraints on this process, and the economic assumptions underlying the revenue projections contained in the Amended 2009 Budget Act, are discussed under “AMENDED 2009 BUDGET ACT” and “THE BUDGET PROCESS.”

State General Obligation Debt and Other Obligations. As of May 1, 2010, the state had outstanding obligations payable principally from the state’s General Fund consisting principally of \$68.9 billion principal amount of general obligation bonds, \$10.0 billion of lease-revenue bonds and \$1.9 billion for repayment of budgetary borrowing from local governments pursuant to Proposition 1A of 2004. As of May 1, 2010, there were approximately \$41.6 billion of authorized and unissued voter-approved general obligation debt and approximately \$9.8 billion of authorized and unissued lease-revenue bonds payable from the General Fund. See “STATE INDEBTEDNESS AND OTHER OBLIGATIONS - Future Issuance Plans.” In addition, certain state agencies and authorities issue revenue obligations for which the General Fund has no liability. Revenue bonds represent obligations payable from state revenue-producing enterprises and projects, which are not payable from the General Fund, and conduit obligations payable only from revenues paid by local governments or private users of facilities financed by the revenue bonds. California has always paid the principal of and interest on its general obligation bonds, general obligation commercial paper notes, lease-revenue obligations and short-term obligations, including revenue anticipation notes (“RANs”) and revenue anticipation warrants (“RAWs”), when due. Detailed information regarding the state’s long-term debt appears in the sections “STATE INDEBTEDNESS AND OTHER OBLIGATIONS” and “STATE DEBT TABLES.”

Financial Statements. APPENDIX A incorporates by reference the Audited Basic Financial Statements of the state for the fiscal year ended June 30, 2009, together with certain information required by governmental accounting and financial reporting standards to be included in the Financial Statements, including a “Management’s Discussion and Analysis” that describes and analyzes the financial position of the state and provides an overview of the state’s activities for the fiscal year ended June 30, 2009. In addition, EXHIBIT 1 to APPENDIX A contains the State Controller’s unaudited reports of General Fund cash receipts and disbursements for the period July 1, 2009 through May 31, 2010. See “FINANCIAL STATEMENTS.”

Population and Economy of the State. The State of California is by far the most populous state in the nation, over 60 percent larger than the second-ranked state according to the 2000 U.S. Census. The state's July 1, 2009 population of about 38.5 million represented over 12 percent of the total United States population.

California's economy, the largest among the 50 states and one of the largest and most diverse in the world, has major components in high technology, trade, entertainment, agriculture, manufacturing, government, tourism, construction and services. The relative proportion of the various components of the California economy closely resembles the make-up of the national economy.

In the 2010-11 May Revision, the Department of Finance projected that the California economy started to recover from the recession in the latter part of 2009, but growth in calendar year 2010 and beyond would be slow and would continue to lag slightly behind the national economic recovery as a whole. As of May 2010, unemployment in the state was 12.4 percent, compared to 12.5 percent in January 2010 and 9.7 percent in January 2009. The U.S. unemployment rate for May 2010 was 9.7 percent.

Demographic and economic statistical information, and a discussion of economic assumptions are included in this APPENDIX A under "AMENDED 2009 BUDGET ACT – Current Economic Conditions and Budget Assumptions" and "ECONOMY AND POPULATION."

Certain Defined Terms.

The following terms and abbreviations are used in this APPENDIX A:

"2008-09 Governor's Budget" means the Governor's Proposed Budget for the 2008-09 Fiscal Year released on January 10, 2008.

"2008-09 May Revision" means the May Revision of the 2008-09 Governor's Budget released on May 14, 2008.

"2008 Budget Act" means the Budget Act for the 2008-09 Fiscal Year adopted on September 16, 2008, together with other related budget legislation.

"2009-10 Governor's Budget" means the Governor's Proposed Budget for the 2009-10 Fiscal Year released on December 31, 2008.

"2009-10 May Revision" means, collectively, the May Revision of the Initial 2009 Budget Act first released May 14, 2009 as subsequently updated.

"2010-11 Governor's Budget" means the Governor's Proposed Budget for the 2010-11 Fiscal Year released on January 8, 2010.

"2010-11 May Revision" means the May Revision of the 2010-11 Governor's Budget released May 14, 2010.

"Amended 2009 Budget Act" means the budget plan for Fiscal Year 2009-10 adopted on February 20, 2009 as amended by the revisions enacted on July 28, 2009 together with other related budget legislation.

"ARRA" means the American Recovery and Reinvestment Act, also known as the federal stimulus bill, enacted on February 17, 2009.

“BSA” means the Budget Stabilization Account created under Proposition 58. See “STATE FINANCES – Budget Reserves.”

“COLA” means a cost of living adjustment.

“ERBs” means Economic Recovery Bonds of the state issued pursuant to Proposition 57. See “STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Economic Recovery Bonds.”

“EXHIBIT 1” means the most recent State Controller’s Unaudited Statement of General Fund Cash Receipts and Disbursements for the period from July 1, 2009 through May 31, 2010 as attached to this APPENDIX A as EXHIBIT 1.

“February 2009 Budget Package” collectively refers to the amendments to the 2008 Budget Act, the Initial 2009 Budget Act, and related budget legislation, all as adopted by the Legislature and signed by the Governor in February 2009.

“Fiscal emergency special session” means a special session of the Legislature called by the Governor to respond to a fiscal emergency as authorized by Proposition 58.

“Initial 2009 Budget Act” means the Budget Act for the 2009-10 Fiscal Year adopted on February 19, 2009, together with other related budget legislation.

“LAO” means the Legislative Analyst’s Office, an entity of the State Legislature.

“SFEU” means the Special Fund for Economic Uncertainties, created pursuant to Government Code Section 16418.

Reference to the “state” as a noun or adjective means the State of California, following the practice of the Department of Finance.

RECENT DEVELOPMENTS

The following significant developments have occurred since the date of the Official Statement for The State Public Works Board \$179,705,000 Lease Revenue Bonds (Trustees of the California State University) 2010 Series B (Various California State University Projects), \$220,575,000 Lease Revenue Bonds (The Regents of the University of California) 2010 Series C (Various University of California Projects) and \$50,485,000 Lease Revenue Bonds (The Regents of the University of California) 2010 and Series D (Helios Energy Research Facility) (Federally Taxable Bonds) dated April 14, 2010.

On May 14, 2010, the Governor released the 2010-11 May Revision. The budgetary proposals contained in that document are described in detail in “STATE FINANCIAL PRESSURE.” The 2010-11 May Revision also disclosed that General Fund revenues in April 2010 were approximately \$3.6 billion lower than projected in the 2010-11 Governor’s Budget, reversing three consecutive months of revenue results which exceeded forecasts. The majority of the shortfall was in personal income tax receipts and occurred for several reasons. First, extraordinary amounts of 2008 capital losses were carried forward into the 2009 tax year. Second, small business owners had less income in 2009 than had been projected at the time of the 2010-11 Governor’s Budget. Lastly, in response to tax law changes, it appears that many quarterly filers paid a greater percentage of their estimated payments prior to April 2010 than was predicted at the time of the 2010-11 Governor’s Budget, thus reducing final payments in April 2010.

On May 4, 2010, a Superior Court judge ruled in favor of the state in the case of *California Redevelopment Association et al. v. Genest et al.* This ruling upheld a provision in the Amended 2009 Budget Act which required redevelopment agencies around the state to transfer \$1.7 billion in fiscal year

2009-10 and \$350 million in fiscal year 2010-11 to support public school funding within their jurisdictions (thereby relieving the state General Fund from an equal amount of payments under Proposition 98). The decision has been appealed by the redevelopment agencies; however, substantially all of the transfers have been made. See “LITIGATION – Budget-Related Litigation.”

On May 19, 2010, a lawsuit was filed on behalf of individual students, school districts and educational organizations against the state (*Robles-Wong et al. v. State of California*) alleging that the state’s system of financing public schools is inconsistent with the mandate of the state Constitution to support public education. The suit seeks a declaration that the current system of school financing is unconstitutional and orders for the Legislature and Governor to devise an adequate system of school financing. See “LITIGATION - Budget-Related Litigation.”

On June 9, 2010, the California Supreme Court granted review of the Court of Appeal decision upholding the Governor’s vetoes of spending in the Amended 2009 Budget Act. There is no time yet set for hearing or decision in this case but the Supreme Court has set an accelerated briefing schedule with all briefings due by July 14, 2010. See “LITIGATION – Budget-Related Litigation.”

On June 14, 2010, the United States Supreme Court granted the state’s petition for review of the decision by a three-judge federal court which ordered a reduction of the state prison population. It is expected that the case will be heard and decided during the Court’s 2010-11 Term. See “LITIGATION – Prison Healthcare Reform and Reduction of Prison Population.”

A large number of initiative petitions have been filed with the Secretary of State seeking to be placed on the November 2, 2010 election ballot; the Secretary of State’s office is in the process of sampling the signatures submitted in order to determine whether a sufficient number of valid signatures was submitted. The Secretary of State is expected to announce by June 24 or June 25, 2010 (after the date of this Official Statement) which measures have qualified; for some measures, counting of signatures may continue after this deadline and the measures may eventually be qualified for the next statewide election after November 2, 2010. A number of the proposals would, if ultimately approved by the voters, impact state finances in various ways, as briefly summarized below. More detailed information about these proposals appears later in this Appendix A, including under the caption “THE BUDGET PROCESS – Proposed November 2010 Initiatives.”

- Legalize sale of marijuana, which could produce increased state revenues if taxes are levied on such sales. (Qualified for the November ballot.)
- Raise the vehicle license fee by \$18 annually and dedicate these funds to support state parks, reducing General Fund expenditures. (Qualified for the November ballot.)
- Restrict the ability of the state to use or borrow money from local governments, and moneys dedicated to transportation financing. (Qualified for the November ballot.)
- Expand the definition of “taxes” under existing Constitutional provisions which require a two-thirds vote of the Legislature to approve.
- Reduce the required vote in each house of the Legislature to adopt the annual budget to a majority from two-thirds.
- Repeal certain corporate tax breaks enacted as part of the Amended 2009 Budget Act, increasing future General Fund revenues.

The following developments have occurred since the date of the Preliminary Official Statement for this offering, dated June 16, 2010:

On June 16, 2010, the California Public Employees' Retirement System ("CalPERS") adopted a proposal that will increase the amount the state must contribute to CalPERS for state employee pensions in fiscal year 2010-11. The state projects this will result in an increase in contributions of approximately \$281 million, approximately 55 percent of which must be paid from the General Fund. See "STATE FINANCES – Pension Trusts - CalPERS."

Subsequent to the 2010- 11 May Revision, the Administration has entered into tentative contract agreements with representatives of several bargaining units, representing more than 22,000 employees. These tentative agreements still require ratification by union members and the Legislature. It is estimated that these contracts would save the state \$72 million (\$43 million General Fund savings) in fiscal year 2010-11. See "OVERVIEW OF STATE GOVERNMENT - Employee Relations."

STATE FINANCIAL PRESSURE

The state experienced a severe economic recession which began in the first quarter of 2008 and ended at some point in the second half of 2009. Personal income fell in the first three quarters of 2009 before increasing moderately in the fourth quarter of 2009. Taxable sales fell sharply in the first half of 2009 before increasing substantially in the fourth quarter of 2009 and the first quarter of 2010. The state's unemployment rate increased from 5.9 percent in January 2008 to 12.4 percent in May 2010. The rate of increase has slowed in 2010.

In response to the most severe economic downturn in the United States since the Great Depression, in the Amended 2009 Budget Act, the state implemented substantial spending reductions, program eliminations, revenue increases, and other solutions in order to close an estimated \$60 billion budget gap over the combined 2008-09 and 2009-10 fiscal years. The state adopted reforms in nearly every area of government to better contain costs in the future. The 2010-11 May Revision includes further reductions to many programs. If these proposals are adopted, it would bring overall General Fund spending to a level well below what it was a decade ago in fiscal year 1998-99 adjusted for population and inflation growth. See "2010-11 PROPOSED GOVERNOR'S BUDGET AND THE 2010-11 MAY REVISION."

The state is slowly emerging from the recession, but economic growth is modest and the level of unemployment is still very high. Consequently, baseline General Fund revenues in fiscal year 2009-10 (consisting of total revenues adjusted to remove temporary tax law changes and one-time receipts) are projected to fall by more than 20 percent from their peak in fiscal year 2007-08. Major components of the revenue decline are capital gains taxes (\$8 billion below peak levels), income tax on wages (about \$6 billion below peak levels), tax on other types of income (\$7 billion below peak levels), sales taxes (\$10 billion below peak levels), corporate taxes (\$2 billion below peak levels), and all other taxes (about \$1 billion below peak levels). Consumer spending driven by easy credit and growth in home values is also not likely to return to prior levels in the foreseeable future. Future revenues will also be affected by the expiration of temporary tax increases enacted in fiscal year 2009-10.

In January 2010, California's projected budget gap for fiscal years 2009-10 and 2010-11 was \$19.9 billion. The deterioration of the state's fiscal condition since adoption of the Amended 2009 Budget Act was due to a combination of lower than projected revenues, failure to achieve expected savings (due in part to adverse court decisions) and population and caseload growth. A Special Session of the Legislature in February 2010 enacted several bills which addressed about \$2.1 billion of this gap. Further reduced revenue estimates (\$0.6 billion) and higher expenditure estimates (\$0.7 billion) added about \$1.3 billion to the gap, so that the 2010-11 May Revision now projects the remaining budget gap at \$19.1 billion. This figure is comprised of a current year shortfall of \$7.7 billion, a fiscal year 2010-11 shortfall of \$10.2 billion and a \$1.2 billion reserve for fiscal year 2010-11.

The 2010-11 May Revision proposes additional solutions to close the remaining budget gap. Additional federal funds (over and above the \$2.2 billion already approved) account for \$3.4 billion in solutions, a reduction from the \$6.9 billion of additional federal funds contained in 2010-11 Governor's Budget. Spending reductions account for \$12.4 billion in solutions. Additional solutions include \$1.3 billion in alternative funding and \$2.1 billion in fund shifts and other revenues. See "2010-11 GOVERNOR'S BUDGET AND THE 2010-11 MAY REVISION" for a more detailed description of these proposals. In response, Legislative leaders have proposed two different budget plans, one of which calls for significant tax increases, and another which would rely on a borrowing plan using certain significant non-General Fund revenues. All these proposals are now being considered by the Legislature. Even if all the Governor's proposals were to be adopted, the Administration still projects that there will be multi-billion dollar budget gaps in future years, as temporary fiscal measures adopted in recent years have to be repaid or temporary tax increases expire.

The sharp drop in revenues over the last two fiscal years also resulted in a significant depletion of cash resources to pay the state's obligations. For a period of one month, in February 2009, the state deferred making certain payments from the General Fund in order to conserve cash resources for high priority obligations, such as education and debt service. By July 2009, as new budget gaps were identified and with the failure to adopt corrective actions, the state's cash resources had dwindled so far that, commencing July 2, 2009, the State Controller began to issue registered warrants (or "IOUs") for certain lower priority obligations in lieu of warrants (checks), which could not be immediately cashed. The registered warrants, the issuance of which did not require the consent of the recipients thereof, bore interest. The registered warrants were all called for redemption on September 4, 2009 once the state was able to access the public credit markets for cash management purposes following enactment of the Amended 2009 Budget Act. No registered warrants were used to make high-priority payments, including debt service on bonds, payments to schools, or employee payrolls. The issuance of state registered warrants in 2009 was only the second time the state has issued state registered warrants since the 1930s.

The 2010-11 May Revision projects that the state will have sufficient cash resources to pay all of its obligations through the end of the current fiscal year, including repayment of all outstanding Revenue Anticipation Notes in June 2010 (a first maturity of \$2.825 billion was paid on May 25, 2010). Legislation enacted during the fiscal emergency special session in early March 2010 will provide the state with additional tools to manage cash in the summer of 2010 and during key months of the budget year by authorizing short-term deferral of certain state payments, primarily to schools and local governments. Proposals to close the budget shortfall will substantially reduce this cash gap. In addition to budget solutions, the state will need to obtain external financing early in the fiscal year. At the Governor's direction, the Department of Finance has begun working with the State Controller's Office and the State Treasurer's Office to develop additional cash solutions as needed to meet the state's payment obligations. See "CASH MANAGEMENT – Cash Management in Fiscal Year 2009-10" and "– Cash Management in Fiscal Year 2010-11"

The national and California economies improved between the 2010-11 Governor's Budget and the 2010-11 May Revision. Output of the national economy grew for the third consecutive quarter in the first quarter of 2010, and California payroll employment grew in four of the six consecutive months ending in March 2010. However, some sectors of both economies have yet to show any positive signs — construction being a prime example.

There are signs that home prices have begun to stabilize and have improved in many regions of the state. Existing home sales peaked during the summer of 2005 and fell steadily through November 2008. A robust recovery in sales took place between November 2008 and November 2009, as sales were boosted by the first-time homebuyers' tax credit. The tax credit was initially set to expire at the end of November 2009, but prior to its expiration, it was extended through April 30, 2010. Following the tax

credit's extension, there was a moderate rebound in sales in March 2010. The tax credit's expiration on April 30, 2010, coupled with severe winter weather, caused home sales to fall again.

The longest and deepest recession in the post-Depression era is most likely over. Both the state and national economies appear poised to make modest comebacks, and many indicators released since the 2010-11 Governor's Budget forecast have been more encouraging than originally expected. Still, the recovery will probably be moderate and prolonged by historical standards.

The pension funds managed by the state's principal retirement systems, the California Public Employees' Retirement System and the California State Teachers' Retirement System, have sustained significant investment losses during the economic downturn and currently have substantial unfunded liabilities which will require increased contributions from the General Fund in future years. The state also has an unfunded liability relating to retirees' post-employment healthcare benefits which was estimated to be \$51.8 billion as of June 30, 2009. See "STATE FINANCES – Pension Trusts."

2010-11 PROPOSED GOVERNOR'S BUDGET AND THE 2010-11 MAY REVISION

The 2010-11 Governor's Budget, released on January 8, 2010, identified an estimated \$19.9 billion budget gap by the end of fiscal year 2010-11 (including funding a \$1.0 billion reserve). The Governor declared a fiscal emergency and called the Legislature into a special session at the time the proposed budget was released, and emphasized the need for the Legislature to implement many of the solutions proposed in the budget immediately to achieve their full value. Based on the Legislature's actions, described below, and other factors, the 2010-11 May Revision reduces the budget gap estimate to \$19.1 billion (including funding a \$1.2 billion reserve) and proposes to close the gap with a combination of expenditure reductions, alternative funding, fund shifts, and federal funds. The 2010-11 May Revision will be the basis for final negotiations between the Governor and the Legislature to reach agreement on the fiscal year 2010-11 budget.

A special session of the Legislature in February 2010 enacted several bills which together with approved federal funds and other administrative actions addressed about \$2.1 billion of the initially projected \$19.9 billion gap. The largest portion of this action was enactment of legislation which repealed a portion of the sales tax and increased the excise tax on gasoline. This legislation is described further below under "AMENDED 2009 BUDGET ACT – Amended 2009 Budget Act – Transportation Funding." Further reduced revenue estimates (\$0.6 billion) and higher expenditure estimates (\$0.7 billion) added about \$1.3 billion to the gap, so that the 2010-11 May Revision now projects the remaining budget gap at \$19.1 billion.

The 2010-11 May Revision projects to end fiscal year 2010-11 with a \$1.2 billion reserve. General Fund revenues and transfers for fiscal year 2010-11 are projected at \$91.5 billion, an increase of \$2.2 billion compared with estimates in the 2010-11 Governor's Budget and of \$3.4 billion compared with revised estimates for fiscal year 2009-10. General Fund expenditures for fiscal year 2010-11 are projected at \$83.4 billion, an increase of \$0.5 billion compared with estimates in the 2010-11 Governor's Budget and a decrease of \$3.2 billion or 3.7 percent compared with revised estimates for fiscal year 2009-10.

The 2010-11 May Revision proposes a combined total of \$19.1 billion of budget solutions for fiscal years 2009-10 and 2010-11. The solutions consist of the following major components:

- \$12.4 billion in expenditure reductions (approximately 64.6 percent of total solutions). The largest item is a \$4.3 billion reduction in Proposition 98 funding by eliminating state funding for child care costs (which are treated as a Proposition 98 school expenditure), \$2.1 billion in reduced state employee costs including having employees pay a larger portion of pension contributions, \$1.2 billion by eliminating the California Work Opportunity and Responsibility to Kids ("CalWORKs") welfare

program, and a series of other reductions, primarily in health and social services programs and about \$1.0 billion in reductions in corrections costs. Some of these program reductions would require approvals or waivers from the federal government. Some of the proposals concerning social service programs would have the effect of shifting some of these costs to counties.

- \$3.4 billion in federal funds solutions (17.7 percent of total solutions) (in addition to the \$2.2 billion of federal funds already approved by the federal government for fiscal year 2010-11). This is substantially reduced from the \$6.9 billion of additional federal funds included in the 2010-11 Governor's Budget. However, on May 28, 2010, the House of Representatives passed H.R. 4213, the "American Jobs and Closing Tax Loopholes Act of 2010," which was originally drafted to include \$24 billion of new federal aid for health care programs for the states. On the House floor, this funding was removed, at an estimated cost to California of about \$1.8 billion of the \$3.4 billion of total additional federal aid expected for fiscal year 2010-11. The Governor and state officials will seek to reverse this action in the Senate. On June 8, 2010, the Senate unveiled its proposed changes to H.R. 4213, which includes the reinsertion of the provision to extend, by two quarters, the enhanced Federal Medical Assistance Percentage ("FMAP") rates put in place by the Recovery Act. If the action is not reversed, the Legislature and Governor will have to make up the shortfall with other budget savings or revenues.

- \$2.1 billion in fund shifts and other revenues (11.0 percent of total solutions). This includes borrowing from Special Funds and delaying repayment of earlier Special Fund loans.

- \$1.3 billion in alternative funding solutions (6.7 percent of total solutions).

The 2010-11 May Revision has the following significant General Fund components, as compared to the 2010-11 Governor's Budget. The expenditures in each area reflect the true program General Fund costs and do not include significant one-time General Fund offsets from Proposition 1A, federal funds, and funds shifted from redevelopment agencies.

1. Natural Resources – General Fund expenditures are proposed to increase by \$258.5 million, or 32.5 percent, compared to the 2010-11 Governor's Budget. The significant adjustments to General Fund budget solutions since the 2010-11 Governor's Budget are as follows:

- An increase of \$140.1 million to reflect the withdrawal of the 2010-11 Governor's Budget proposal to fund state parks from Tranquillon Ridge oil revenues.
- An increase of \$124 million to reflect the loss of revenues to fund the Department of Forestry and Fire Protection due to the delay in the enactment of the Emergency Response Initiative.

2. Health and Human Services – General Fund expenditures are proposed to decrease by \$796 million, or 2.9, compared to the 2010-11 Governor's Budget. The significant adjustments to General Fund budget solutions since the 2010-11 Governor's Budget are as follows:

- A decrease of \$1.1 billion from eliminating the CalWORKs program effective October 1, 2010.
- An increase of \$550 million to reflect that the proposal to shift state and local California Children and Families Act of 1998 (Proposition 10) revenues for five years to offset General Fund costs in various health and human services programs was not adopted in time to be considered by the voters in the June election.

- A decrease of \$602 million to the Food Stamp and Child Welfare Services programs due to a shift of county mental health realignment funding to county social services programs.

3. Corrections and Rehabilitation – General Fund expenditures are proposed to increase by \$111.6 million, or 1.4 percent compared to the 2010-11 Governor’s Budget. The significant adjustments to the General Fund budget since the 2010-11 Governor’s Budget are:

- An increase of \$291.6 million in fiscal year 2010-11 to remove estimated savings related to the Felony Prison Term Reform proposal.
- A decrease of \$243.8 million in fiscal year 2010-11 is associated with a proposal to have non-sex offender, non-serious, non-violent offenders convicted with sentences of three years or less to serve their felony sentence in local jails.
- An increase of \$100.9 million General Fund in fiscal year 2010-11 to reflect revised savings estimates associated with prison reforms included in the Amended 2009 Budget Act.

4. Proposition 98 – The 2010-11 May Revision maintains the Governor’s commitment to avoid additional cuts to K-14 education despite the need to close a deficit of \$19.1 billion. The 2010-11 Governor’s Budget proposed maintaining state funding for schools at approximately the same level for fiscal year 2010-11 as schools received in fiscal year 2009-10.

- For fiscal year 2010-11, the Proposition 98 funding level is \$48.4 billion, of which \$35 billion is General Fund. This level reflects elimination of state funding for child care only and does not reduce funding for K-14 education. As a result of the elimination of the child care program, the Proposition 98 Guarantee is rebenched downward by \$1.4 billion. Additionally, the Administration proposes a fund shift of \$386 million from on-going Proposition 98 funding to one-time reappropriations. Aside from rebenching the Proposition 98 guarantee to reflect the elimination of child care, K-14 funding in the 2010-11 May Revision remains largely unchanged from the 2010-11 Governor’s Budget level.

5. Borrowing Costs – The 2010-11 May Revision proposes a decrease of \$419.4 million, or 6.7 percent, in General Fund expenditures for borrowing in fiscal year 2010-11, compared to the 2010-11 Governor’s Budget.

- General Fund expenditures for debt service in fiscal year 2010-11 will decrease by \$197.5 million, or 3.4 percent, to reflect lower-than-anticipated general obligation (GO) debt service costs for bonds issued to pay for infrastructure projects and other bond-funded programs in the spring of 2010 and reduced interest rate assumptions for future GO bond sales.
- For cash management, internal and external cash flow borrowing costs have decreased by \$190 million, or 35.2 percent, in fiscal year 2010-11 due to lower-than-projected interest costs.

6. Federal Funding Assumptions – The 2010-11 May Revision includes an estimated \$5.6 billion (as compared to \$6.9 billion in the 2010-11 Governor’s Budget) in fiscal year 2010-11 federal funds to offset General Fund expenditures (of which \$2.2 billion has already been approved by the federal government). The majority of these federal funds are ARRA funds.

7. Employee Compensation Changes – The 2010-11 May Revision proposes to decrease General Fund expenditures by \$645.7 million in fiscal year 2010-11 as compared to the Governor’s Budget. The significant General Fund adjustments since the 2010-11 Governor’s Budget are as follows:

- A decrease of \$445.7 million associated with implementation of a one-day-per-month personal leave program for all state civil service employees from July 1, 2010 until June 30, 2011.
- A decrease of \$200 million associated with anticipated savings from partial reimbursement for reinsurance costs for early retirees included in the Federal Health Care Reform Act, passed in March of 2010.

8. Budget Stabilization Account - The Governor suspended the annual transfer of money from the General Fund to the Budget Stabilization Account due to the condition of the General Fund.

The following table summarizes the 2010-11 Governor’s Budget and 2010-11 May Revision:

TABLE 1
2010-11 General Fund Budget Summary
(Millions)

	<u>As of 2010-11 Governor’s Budget (January 8, 2010)</u>	<u>As of 2010-11 May Revision (May 14, 2010)</u>
Prior Year Resources Available	\$(3,863) ⁽¹⁾	\$(5,305) ⁽¹⁾
Revenues and Transfers	\$89,322	\$91,451
Expenditures	\$82,901	\$83,404
Fund Balance	<u>\$2,558</u>	<u>\$2,742</u>
<i>Reserve for Liquidation of Encumbrances</i>	\$1,537	\$1,537
<i>Special Fund for Economic Uncertainties</i>	\$1,021	\$1,205
<i>Budget Stabilization Account</i>	\$0	\$0
Total Available Reserve	\$1,021	\$1,205

⁽¹⁾ Includes a carry-over adjustment of \$890 million from amnesty-related payments, of which \$510 million will have to be refunded or will reduce revenues in future years, including a \$230 million adjustment in fiscal year 2010-11 and \$280 million in fiscal year 2011-12. See “STATE FINANCES—Sources of Tax Revenue – Tax Amnesty Program.”

The state will be required to obtain external financing, as it normally does once a budget is enacted, to manage its cash flow needs in fiscal year 2010-11. If enactment of a budget is substantially delayed, the state may face difficulties in managing its cash flow. See “CASH MANAGEMENT” below.

Development of Revenue Estimates

The development of the forecast for the major General Fund revenues begins with a forecast of national economic activity prepared by an independent economic forecasting firm. The Department of Finance’s Economic Research Unit, under the direction of the Chief Economist, adjusts the national forecast based on the Department’s economic outlook. The national economic forecast is used to develop a forecast of similar indicators for California activity.

After finalizing the forecasts of major national and California economic indicators, revenue estimates are generated using revenue forecasting models developed and maintained by the Department of Finance. With each forecast, adjustments are made for any legislative, judicial, or administrative changes, as well as for recent cash flow results. The forecast is updated twice a year and released with the Governor's Budget by January 10 and the May Revision by May 14.

Current Economic Conditions

National Economy. Output of the national economy (real GDP) grew 3 percent in the first quarter of 2010—the third consecutive quarter of growth. Consumers were largely responsible for the gain by increasing their spending by the largest amount in four years. Retail sales rose in the first quarter of 2010, posting their strongest growth since the end of 2007. Vehicle sales have begun a modest recovery.

Unemployment eased slightly while nonfarm payroll expanded during each of the first five months of 2010.

Residential construction fell by almost 11 percent in the first quarter of 2010. Home building increased in the last two quarters of 2009, but largely because of the first-time home buyer federal tax credit program. The credit was first applicable to homes purchased between April 2008 and July 2009. The program was extended to April 30, 2010 and expanded.

Investment by businesses in equipment and software expanded in the first quarter of 2010. Manufacturing activity increased for the tenth consecutive month in May 2010, according to the Institute for Supply Management (ISM) index.

U.S. exports and imports grew in the first quarter, reflecting growing economies abroad and increased demand for imports at home. On net, however, international trade subtracted from domestic economic growth in the first quarter.

California Economy. California does not have a quarterly measure of economic output that could be used to compare its economic growth to that of the nation. However, other economic indicators show that California's economy was hit harder by the recession than the economies of most other states. Still there are clear signs that economic growth in California improved during the second half of 2009 and the early months of 2010.

For example, personal income fell in the first three quarters of 2009 before increasing moderately in the fourth quarter of 2009 and the first quarter of 2010. After falling for six consecutive quarters, taxable sales grew in the third and fourth quarters of 2009 and the first quarter of 2010. The state unemployment rate was 12.4 percent in May 2010. In comparison, the national unemployment rate was 9.7 percent.

The state's housing sector is showing some signs of recovery. Existing home sales have stabilized around the half-million unit rate (seasonally-adjusted and annualized) and the median sales price rose by 23 percent from May 2009 to May 2010, bringing the median price of these homes to approximately \$324,000. Unsold inventory trended downward in 2009, as did the number of days needed to sell a home. However, additional foreclosures may result from the resetting of rates on adjustable rate mortgages between 2010 and 2012, the commencement of amortization during the same period on mortgages that were previously in an interest-only mode, and the expiration of the mortgage foreclosure relief program. The impact of the resetting may be mitigated by the resets being spread out over multiple years, and may be further mitigated if mortgage interest rates remain low.

The worst of the housing slump, though, may be over. Home building permitting—which suffered a long, steady three-year decline starting in 2006 - bottomed out early in 2009 and increased on a year-over-year basis at the start of 2010, but at a very low level.

Made-in-California exports were down 17 percent in 2009. The decline was widely spread across countries, reflecting the global nature of the economic downturn. Large declines in technology, transportation, and machinery exports were instrumental in the decline. However, with global economic conditions improving, California exports increased 19 percent year-over-year in the first quarter of 2010.

Budget Assumptions

The revenue and expenditure assumptions utilized in connection with the 2010-11 May Revision were based upon certain estimates of the performance of the California, national, and global economies in calendar years 2010 and 2011.

In April 2010, the Department of Finance published the following estimates for the state's economic performance in calendar years 2010 and 2011, which were used in predicting revenues and expenditures for the 2010-11 May Revision. Also shown is the Department of Finance's previous forecast for the same calendar years, which was contained in the 2010-11 Governor's Budget.

TABLE 2
Estimates of State's Economic Performance
(Dollars in Billions)

	For Calendar Year 2010		For Calendar Year 2011	
	2010–11 Governor's Budget (January 8, 2010)	2010–11 May Revision (May 14, 2010)	2010–11 Governor's Budget (January 8, 2010)	2010–11 May Revision (May 14, 2010)
Non-Farm Wage and Salary Employment (Thousands)	14,063	13,985	14,239	14,229
Percent Change from prior year	(0.7)%	(0.7)%	1.3%	1.7%
Personal Income	\$1,597	\$1,609	\$1,655	\$1,682
Percent Change from prior year	2.4%	3.2%	3.6%	4.5%
Housing Permits (Thousands)	61	64	101	105
Consumer Price Index	2.5%	2.4%	2.6%	2.7%

Source: State of California, Department of Finance.

Summary of State Revenues and Expenditures

The table below presents the actual revenues, expenditures and changes in fund balance for the General Fund for fiscal years 2006-07, 2007-08, and 2008-09, the estimated results for fiscal year 2009-10 and the proposed budgeted amounts for fiscal year 2010-11.

TABLE 3
Statement of Estimated Revenues, Expenditures,
and Changes in Fund Balance – General Fund
(Budgetary Basis) ^(a)
Fiscal Years 2006-07 Through 2010-11
(Dollars in Millions)

	2006-07	2007-08	2008-09	Estimated ^{(b) (c)} 2009-10	Proposed ^{(b) (c)} 2010-11
Fund Balance—Beginning of Period	\$ 11,255.5	\$ 5,972.4	\$ 5,684.8	\$ (4,743.8)	\$ (5,305.7)
Restatements					
Prior Year Revenue, Transfer Accrual					
Adjustments	(20.0)	(270.7)	181.8	(2,168.4)	—
Prior Year Expenditure, Accrual					
Adjustments	<u>206.5</u>	<u>(288.3)</u>	<u>(51.4)</u>	<u>1,550.6</u>	<u>—</u>
Fund Balance—Beginning of Period, as					
Restated	\$ 11,442.0	\$ 5,413.4	\$ 5,815.2	\$ (5,361.6)	\$ (5,305.7)
Revenues	\$ 95,906.5	\$ 98,515.2	\$ 81,960.8	\$ 86,073.8	\$ 90,335.4
Other Financing Sources					
Economic Recovery Bonds ^(d)	—	3,313.0	—	—	—
Transfers from Other Funds	994.0	2,565.2 ^(e)	1,054.9	447.4	1,116.0
Other Additions	<u>84.4</u>	<u>99.8</u>	<u>40.3</u>	<u>—</u>	<u>—</u>
Total Revenues and Other Sources	\$ 96,984.9	\$104,493.2	\$ 83,056.0	\$ 86,521.2	\$ 91,451.4
Expenditures					
State Operations ^(f)	\$ 24,682.8	\$ 26,318.5	\$ 24,111.3	\$ 23,162.2	\$ 24,383.5
Local Assistance	73,899.7	74,825.3	67,800.8	61,661.5	58,709.6
Capital Outlay	2,903.1	1,601.6	1,137.4	124.9	227.3
Unclassified	—	—	—	1,516.7	83.4
Other Uses					
Transfer to Other Funds	<u>968.9</u>	<u>1,476.4</u>	<u>565.5</u>	<u>—^(g)</u>	<u>—^(g)</u>
Total Expenditures and Other Uses	\$ 102,454.4	\$104,221.8	\$ 93,615.0	\$ 86,465.3	\$83,403.8
Revenues and Other Sources Over or					
(Under) Expenditures and Other Uses	\$ (5,469.6)	\$ 271.4	\$(10,559.0)	\$ 55.9	\$ 8,047.6
Fund Balance					
Reserved for Encumbrances	\$ 842.1	\$ 1,061.6	\$ 1,536.7	\$ 1,536.7	\$ 1,536.7
Reserved for Unencumbered Balances					
of Continuing Appropriations ^(h)	1,721.3	1,196.2	1,232.9	—	—
Unreserved—Undesignated ⁽ⁱ⁾	<u>3,409.0</u>	<u>3,427.0</u>	<u>(7,513.4)</u>	<u>(6,842.4)</u>	<u>1,205.2</u>
Fund Balance—End of Period	\$ 5,972.4	\$ 5,684.8	\$ (4,743.8)	\$ (5,305.7)	\$ 2,741.9

(a) These statements have been prepared on a budgetary basis in accordance with state law and some modifications would be necessary in order to comply with generally accepted accounting principles ("GAAP"). The Supplementary Information contained in the state's Audited Basic Financial Statements for the year ended June 30, 2009, incorporated by reference into this APPENDIX A, contains a description of the differences between the budgetary basis and the GAAP basis of accounting and a reconciliation of the June 30, 2009 fund balance between the two methods. See "FINANCIAL STATEMENTS."

(b) Estimates are shown net of reimbursements and abatements.

(c) Estimated as of the 2010-11 May Revision, May 14, 2010.

(d) Reflects the issuance of Economic Recovery Bonds sufficient to provide net proceeds to the General Fund in fiscal year 2007-08.

(Remainder of footnotes on following page.)

- (e) This amount includes the transfer of \$1.5 billion from the BSA to the General Fund as stated in the 2007 Budget Act.
- (f) Includes debt service on general obligation bonds. The estimated amount of debt service is \$4.739 billion for fiscal year 2009-10 and \$4.813 billion for fiscal year 2010-11, net of federal Build America Bond subsidy. For fiscal years 2009-10 and 2010-11, the 2010-11 May Revision includes reimbursement to the General Fund from special funds of approximately \$243 million in fiscal year 2009-10 and \$949 million in fiscal year 2010-11 to offset debt service costs of certain bonds. Debt service amounts for earlier years are set forth in the table titled "Outstanding State Debt Fiscal Years 2004-05 through 2008-09" under "STATE DEBT TABLES."
- (g) "Transfer to Other Funds" is included either in the expenditure totals detailed above or as "Transfers from Other Funds."
- (h) For purposes of determining whether the General Fund budget, in any given fiscal year, is in a surplus or deficit condition, see Chapter 1238, Statutes of 1990, amending Government Code Section 13307. As part of the amendment, the unencumbered balances of continuing appropriations which exist when no commitment for expenditure is made should be an item of disclosure, but the amount shall not be deducted from the fund balance. Accordingly, the General Fund condition included in the 2010-11 May Revision includes the unencumbered balances of continuing appropriations of \$364.8 million in fiscal year 2009-10 and \$.5 million in fiscal year 2010-11. However, in accordance with Government Code Section 12460, the State's Budgetary/Legal Basis Annual Report reflects a specific reserve for the encumbered balance for continuing appropriations.
- (i) Includes SFEU. The Department of Finance generally includes in its estimates of the SFEU and set aside reserves, if any, the items reported in the table under "Reserved for Unencumbered Balances of Continuing Appropriations," and "Unreserved – Undesignated." The Department of Finance estimates a \$6.84 billion SFEU deficit and total reserve on June 30, 2010, and projects a \$1.21 billion SFEU balance and total reserve on June 30, 2011, based upon the 2010-11 May Revision. These amounts include the suspension of Proposition 58 transfers to BSA in fiscal years 2009-10 and 2010-11 as estimated at 2010-11 May Revision. The BSA was created pursuant to the California Balanced Budget Act (Proposition 58), enacted in 2004.

Source: Fiscal years 2006-07 to 2008-09: State of California, Office of the State Controller.

Fiscal years 2009-10 and 2010-11: State of California, Department of Finance.

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Revenue and Expenditure Assumptions

The table below presents the Department of Finance's budget basis statements of major General Fund revenue sources and expenditures for fiscal years 2008-09, 2009-10 and 2010-11, as set forth in the 2010-11 May Revision.

TABLE 4
General Fund Revenue Sources and Expenditures
Fiscal Years 2008-09 Through 2010-11
(Dollars in Millions)

Source	Revenues Fiscal Years			
	2008-09 Actual (as of 2010- 11 May Revision)	2009-10 Amended (as of July 2009)	2009-10 Revised (as of 2010- 11 May Revision)	2010-11 Proposed (as of 2010- 11 May Revision)
Personal Income Tax	\$43,376	\$48,868	\$44,021	\$46,245
Sales and Use Tax	23,753	27,609	26,852	26,967
Corporation Tax	9,536	8,799	9,386	9,779
Insurance Tax	2,054	1,913	2,027	1,967
All Other	4,053	2,352	4,235	6,493
Transfer to/from BSA Reserve ^(a)	--	--	--	--
Total Revenues and Transfers	<u>\$82,772</u>	<u>\$89,541</u>	<u>\$86,521</u>	<u>\$91,451</u>

Function	Expenditures Fiscal Years			
	2008-09 Actual	2009-10 Amended	2009-10 Revised	2010-11 Proposed
K-12 Education	\$34,092	\$35,042	\$35,869	\$35,133
Health and Human Services	28,278	24,953	24,408	22,859
Higher Education	10,099	10,547	10,570	11,794
Corrections and Rehabilitation	9,705	8,210	8,186	8,981
Legislative, Judicial and Executive	3,719	1,884	1,828	2,905
Tax Relief ^(b)	480	445	438	442
Natural Resources	1,773	1,842	1,873	2,037
State and Consumer Services	534	569	510	599
Business, Transportation and Housing	1,679 ^(c)	2,585 ^(d)	2,512 ^(e)	765 ^(f)
All Other	581	-1,494 ^(g)	271	-2,111 ^(h)
Total Expenditures	<u>\$90,940</u>	<u>\$84,583</u>	<u>\$86,465</u>	<u>\$83,404</u>

(a) In fiscal years 2008-09, 2009-10, and 2010-11 Proposition 58 transfers to the BSA are suspended as part of the solutions to close the budget gap.

(b) Reflects funding for only the Homeowners' Property Tax Relief Program and \$1,000 for the Williamson Act, essentially suspending the program, beginning in fiscal year 2009-10.

(Remainder of footnotes on following page.)

- (c) Includes \$1.332 billion in Proposition 42 transfers from the General Fund to the Transportation Investment Fund, \$82.7 million partial repayment of prior year Proposition 42 loans, and \$264.9 million debt service.
- (d) Includes \$1.441 billion in Proposition 42 transfers from the General Fund to the Transportation Investment Fund, \$82.7 million partial repayment of prior year Proposition 42 loans, \$551.7 million debt service, and \$497 million vehicle license fee and General Fund revenues transferred to the Local Protection and Safety Account.
- (e) Includes \$1.433 billion in Proposition 42 transfers from the General Fund to the Transportation Investment Fund, \$83.4 million partial repayment of prior year Proposition 42 loans, \$565.9 million debt service, and \$415.8 million vehicle license fee and General Fund revenues transferred to the Local Protection and Safety Account
- (f) Includes \$83.4 million partial repayment of prior year Proposition 42 loans, \$226.0 million debt service, and \$441.5 million vehicle license fee and General Fund revenues transferred to the Local Protection and Safety Account.
- (g) Nearly \$5.0 billion of offset from federal stimulus moneys is no longer included in the “All Other” category but is distributed in each program category above (i.e. K-12 Education, Health and Human Services, Higher Education etc.)
- (h) Includes \$1.6 billion for additional federal funds that are not allocated to specific dollars or programs at this time.

Source: State of California, Department of Finance. Figures in this table may differ from the figures in Table 9; see “Note” to Table 9.

LAO Report

On May 18, 2010, the Legislative Analyst’s Office released its analysis of the 2010-11 May Revision “The 2010-11 Budget: Overview of the May Revision” (the “May 2010 LAO Report”). The May 2010 LAO Report (which is available on the website of the Legislative Analyst’s Office) in a section titled “LAO’s Overall Assessment of the May Revision” contains the following observations:

“We believe that the administration’s estimate of the size of the state’s budget problem in 2010-11 is sound. . . . [W]e believe the May Revision revenue forecast is quite reasonable and realistic. . . . In 2010-11, our expectation for the big three tax revenues is about \$1 billion (1 percent) higher than the administration. . . .

As part of our review of the May Revision, we have estimated how [a] persistent long-term [budget gap] would change under the Governor’s proposals. . . . [Generally assuming the Governor’s proposals are adopted], the ongoing gap between General Fund revenues and expenditures would be significantly reduced but not eliminated. . . . [S]hortfalls would range between \$4 billion and \$7 billion through 2014-15 . . . Given this ongoing shortfall even under the sharp spending reductions proposed by the Governor, it is unrealistic for the Legislature to eliminate the long-term problem entirely this year. . . .

[T]he Governor’s budget proposals include several billion dollars of assumptions – both on the revenue and expenditure sides of the ledger – that carry with them moderate or major implementation risk. In fact, we cannot imagine *any* balanced budget solution this year that could avoid some level of risky assumptions.”

Future Deficits

Since many of the budget balancing actions in the Amended 2009 Budget Act and 2010-11 May Revision are either one-time actions, or involve loans which have to be repaid, or are based on temporary revenue increases or the non-recurring receipt of federal stimulus funds, budget gaps of several billions of dollars a year are expected to recur in fiscal year 2011-12 and subsequent years. The Department of Finance has projected that, assuming adoption of the Governor’s 2010-11 Budget as updated in the 2010-11 May Revision (including fiscal year 2009-10 adjustments), and various assumptions concerning revenues in future years, the state would, in the absence of taking additional steps to balance its budget, face an “operating deficit” (expenditures exceeding revenues in the same fiscal year) of \$6.3 billion in fiscal year 2011-12, \$6.3 billion in fiscal year 2012-13 and \$3.1 billion in fiscal year 2013-14. These projections assume, for instance, that transfers to the BSA will be suspended in each of these coming years, and that the state will ultimately prevail in the pending and threatened litigation concerning budget actions.

The state is in the process of studying the recently enacted federal health care reform and its implications. Among other things, the law: (1) expands Medi-Cal coverage beginning January 1, 2014; (2) requires specified rate increases for primary care and outpatient services beginning in 2013; and (3) prohibits California from restricting eligibility primarily for the Medi-Cal and Healthy Families programs (other health programs may also be affected, pending further review) before the new coverage requirements go into effect in 2014. Health care reform may result in a significant net increase of General Fund program costs in fiscal year 2013-14 and beyond. The net impact of health care reform on the General Fund will depend on a variety of factors, including levels of participation and potential savings resulting from the reform.

The financial condition of the state is subject to a number of other risks in the future, including particularly potential significant increases in required state contributions to the California Public Employees' Retirement System and the California State Teachers' Retirement System, increased financial obligations related to Other Post-Employment Benefits, potential adverse decisions in litigation and increased debt service. See "STATE FINANCES - Pension Trusts" and "STATE INDEBTEDNESS AND OTHER OBLIGATIONS - Future Issuance Plans."

AMENDED 2009 BUDGET ACT

Background

The state's budget for fiscal year 2009-10 was enacted in an unusual sequence. The 2008 Budget Act was one of the latest ever enacted, having been delayed until mid-September 2008 as a result of the difficulty of balancing the budget with reduced revenues, as declining economic conditions were already evident. The 2008 Budget Act, however, was based on revenue assumptions made in the spring of 2008, which proved to be greatly overstated by the time actual revenue results for September and October 2008 were received. With the financial market meltdown starting in September 2008, which resulted in massive federal assistance and caused large drops in stock market and other asset values and reductions in consumer spending, projections of tax revenues, which are heavily dependent on capital gains taxes and sales taxes, had to be dramatically reduced. In November 2008, the Governor announced that the 2008 Budget Act would be billions of dollars out of balance, and called several special sessions of the Legislature to enact corrective actions.

Because of strong disagreement in the Legislature as to the amount of corrective actions which would be taken by tax increases versus expenditure reductions, a compromise was not reached until February 2009. At that time, the February 2009 Budget Package was enacted which included modifications to the 2008 Budget Act and the enactment, more than four months early, of a full budget act for fiscal year 2009-10. For more details on the 2008 Budget Act, see "PRIOR FISCAL YEARS' BUDGETS – 2008 Budget Act."

Initial 2009 Budget Act

The Initial 2009 Budget Act was adopted by the Legislature on February 19, 2009, along with a number of implementing measures, and signed by the Governor on February 20, 2009. In February, the state enacted \$36 billion in solutions to what was then estimated to be a \$42 billion General Fund budget gap for the combined 2008-09 and 2009-10 fiscal years. It also provided for five budget-related measures that would have provided an estimated \$6 billion in additional budget solutions, to be placed before the voters on May 19, 2009. These measures were all rejected by the voters.

Under the Initial 2009 Budget Act, based on then-current assumptions about the state's financial circumstances, and assuming receipt of approximately \$8.0 billion of federal stimulus funds to offset General Fund costs (\$4.9 billion of which was assumed to be received in fiscal year 2009-10) and voter approval of various ballot measures, General Fund revenues and transfers were projected to increase 9.3

percent, from \$89.4 billion in fiscal year 2008-09 to \$97.7 billion in fiscal year 2009-10. The Initial 2009 Budget Act contained General Fund appropriations of \$92.2 billion, compared to \$94.1 billion in fiscal year 2008-09, a 2.0 percent decrease. The June 30, 2010 total reserve was projected to be \$2.1 billion, an increase of \$5.5 billion compared to the estimated June 30, 2009 reserve deficit of negative \$3.4 billion. The Amended 2009 Budget Act reflected vetoes by the Governor of \$1.305 billion in appropriations from the General Fund, special funds, and bond funds (including \$957.2 million in General Fund appropriations). See “STATE FINANCES – Budget Reserves – Budget Stabilization Account” for an explanation of the budgetary reporting method for revenues.

After adoption of the Initial 2009 Budget Act, the state continued to experience significant declines in revenues and other financial pressures. On May 14, 2009, the Governor released the 2009-10 May Revision. Together with subsequent revisions, the 2009-10 May Revision identified a further budget shortfall through the 2009-10 fiscal year of approximately \$24 billion.

Amended 2009 Budget Act

On July 24, 2009, the Legislature approved the amendments to the Initial 2009 Budget Act and the Governor signed the Amended 2009 Budget Act on July 28, 2009. The Amended 2009 Budget Act included another \$24 billion in solutions to address the further deterioration of the state’s fiscal situation identified in the 2009-10 May Revision.

Under the Amended 2009 Budget Act, General Fund revenues and transfers were projected to increase 6.4 percent, from a revised \$84.1 billion in fiscal year 2008-09 to \$89.5 billion in fiscal year 2009-10. A significant element of this increase was projected to come from certain new revenues enacted in February 2008. See “New Revenues” below. The Amended 2009 Budget Act contained General Fund appropriations of \$84.6 billion in fiscal year 2009-10, compared to \$91.5 billion in fiscal year 2008-09, a 7.5 percent decrease. The June 30, 2010 total reserve was projected to be \$500 million as compared to the revised June 30, 2009 reserve of negative \$4.5 billion. Subsequent events after adoption of the Amended 2009 Budget Act exceeded the reserve such that the Administration now (as of May 2010) projects the fiscal year will end with a negative balance of \$6.8 billion at June 30, 2010. The discussion below describes some of the elements of the Amended 2009 Budget Act which could not be implemented as originally expected. See also “Fiscal Year 2009-10 Revised Estimates in the 2010-11 Governor’s Budget” for a discussion of new revenue and expenditure estimates.

The Amended 2009 Budget Act contained the following major General Fund components:

1. Addressing the Deficit – The \$60 billion in budget solutions adopted for the combined fiscal years 2008-09 and 2009-10 (\$36 billion in solutions were adopted in February 2009 and \$24 billion in July 2009) were wide-ranging and touched all three of the state’s major revenue sources (personal income taxes, corporation taxes and sales and use taxes). Spending cuts were implemented in virtually every state program that receives General Fund support. The budget solutions included spending reductions of \$31.0 billion (52 percent of total solutions). The spending reductions consisted primarily of reductions in education spending under Proposition 98 (\$14.9 billion reduction), higher education (\$3.3 billion reduction), employee compensation (\$2.0 billion reduction), and reductions in other spending due to the use of redevelopment agency revenues and fund balances to pay costs that would otherwise be payable from the General Fund (\$1.7 billion reduction). The budget solutions also included an estimated receipt of \$8.0 billion (13 percent of total solutions) of federal stimulus funds to be used to offset General Fund expenditures. Additional solutions included \$12.5 billion of tax increases (21 percent of total solutions), and \$8.4 billion of other solutions (14 percent of total solutions). Significant elements of the budget solutions include:

- *Proposition 1A of 2004 Borrowing from Local Governments* – The Amended 2009 Budget Act authorized the state to exercise its borrowing authority under Proposition 1A of 2004 to borrow from local agencies up to 8 percent of their fiscal year 2008-09 property tax revenues. The state utilized this authority and the borrowing generated \$1.998 billion that was used to offset state General Fund costs for a variety of court, health, corrections and K-12 programs. The borrowed sums must be repaid by the state, with interest, by June 15, 2013. See “STATE INDEBTEDNESS AND OTHER OBLIGATIONS - Obligations in Connection with Proposition 1A of 2004” and “STATE FINANCES - Local Governments.”
 - *Redevelopment Agency Borrowing* – The Amended 2009 Budget Act also contained a shift of \$1.7 billion in local redevelopment agency funds to the state from current revenues and reserves in fiscal year 2009-10 and \$350 million in fiscal year 2010-11. Under the Amended 2009 Budget Act these revenues are ultimately shifted to schools that serve the redevelopment areas. An association of redevelopment agencies, and a group of counties, have filed separate suits to block this transfer which if successful could adversely affect the state’s financial condition. However, substantially all of the required transfers have been made. In May 2010, a trial court ruled in favor of the state in this challenge; the decision has been appealed. Subsequent to enactment of the Amended 2009 Budget Act the Legislature also passed clean-up legislation authorizing redevelopment agencies to borrow from prior-year balances in the Low and Moderate Income Housing Funds to make the fiscal years 2009-10 and 2010-11 payments. See “AMENDED 2009 BUDGET ACT – Budget Risks” and “STATE FINANCES -- Local Governments.”
 - *Payroll Shift* – One-time savings of \$1.618 billion (\$937.6 million General Fund) from shifting the payments for employee payroll covering the pay period ending June 30, 2010 to July for all entities that are paid through the Uniform State Payroll System. This shift will be repeated on an annual basis. This payment shift excludes the University of California, Community Colleges, staff of the Legislature, the California Exposition and State Fair, and local trial courts.
 - *State Compensation Insurance Fund Sale* – One-time revenues of \$1 billion from the sale of certain assets of the State Compensation Insurance Fund (“SCIF”). Because of pending litigation, the state no longer expects the sale of SCIF assets to occur in fiscal years 2009-10 or 2010-11. See “LITIGATION - Budget-Related Litigation - Action Challenging Proposed Sale of State Compensation Insurance Fund Assets.”
2. Federal Stimulus – The Amended 2009 Budget Act assumed the receipt of at least \$8 billion from the American Recovery and Reinvestment Act of 2009 (“ARRA”) to offset General Fund expenditures in fiscal years 2008-09 and 2009-10. Final estimates put this amount at about \$8.7 billion. As of May 19, 2010 approximately \$7.8 billion has been received by the state, and the remainder is expected by the end of June 2010. See “STATE FINANCES – American Recovery and Reinvestment Act.”
 3. Cash Flow Management – The deterioration of revenues resulted in a cash shortage in fiscal years 2008-09 and 2009-10. In order to manage cash flow and provide for timely payments of the state’s obligations, the Amended 2009 Budget Act included a number of cash solutions to better balance timing of receipts and disbursements. Further cash management solutions were adopted by the Legislature as part of a special session in early 2010. The state expects to be able to meet its payment obligations in the final months of fiscal year 2009-10 through administrative actions. See “CASH MANAGEMENT.”

4. Proposition 98 – As of the Amended 2009 Budget Act, the Proposition 98 Guarantee for fiscal year 2009-10 was projected to be \$50.4 billion, of which \$35.0 billion was the General Fund portion. See “STATE FINANCES – Proposition 98 and K-14 Funding.” As of the 2010-11 May Revision, the Proposition 98 Guarantee for fiscal year 2009-10 is projected to be \$49.9 billion, of which \$34.7 billion is the General Fund portion.
5. K-12 Education – The Amended 2009 Budget Act included \$66.7 billion for K-12 education programs for fiscal year 2009-10 of which \$35.0 billion was funded from the General Fund. As of the Amended 2009 Budget Act, total per-pupil expenditures were projected to be \$11,259 in fiscal year 2009-10. Revised estimates in the 2010-11 May Revision reflect \$65.9 billion for K-12 education programs for fiscal 2009-10 of which \$35.9 billion is funded from the General Fund. Revised estimates in the 2010-11 May Revision reflect that total per-pupil expenditures are projected to be \$11,121 in fiscal year 2009-10.
6. Higher Education – The Amended 2009 Budget Act reflected total funding of \$20.9 billion, including \$12.5 billion General Fund and Proposition 98 sources, for all major segments of Higher Education (excluding infrastructure and stem cell research), including approximately \$2 billion from local property taxes that are included in the Proposition 98 Guarantee and expended on California Community Colleges. The 2010-11 May Revision includes total funding of \$20.5 billion for fiscal years 2009-10, including \$12.6 billion General Fund and Proposition 98 sources for all major segments of Higher Education (excluding infrastructure and stem cell research).
7. Health and Human Services – The Amended 2009 Budget Act included \$24.8 billion in non-Proposition 98 General Fund expenditures for Health and Human Service Programs for fiscal year 2009-10. Due to the state’s severe fiscal shortfall, the Amended 2009 Budget Act included \$5.8 billion in proposed General Fund expenditure reductions in Health and Human Services programs in fiscal year 2009-10. Apart from the reduction in General Fund funding for these programs, the Amended 2009 Budget Act reflected significant General Fund relief for Health and Human Services programs resulting from the ARRA. As of the 2010-11 May Revision, non-Proposition 98 General Fund expenditures for Health and Human Service Programs for fiscal year 2009-10 are projected to be \$24.9 billion.
8. Transportation Funding –The Amended 2009 Budget Act included \$1.441 billion of General Fund expenditures to fully fund local transportation programs under Proposition 42 in fiscal year 2009-10. Additionally, the Amended 2009 Budget Act directed \$1.015 billion of funds from sales tax on fuels to offset costs of programs otherwise likely to be funded from the General Fund such as debt service on transit bonds and other transportation programs. Of this amount approximately \$878 million was for uses substantially similar to those that were the subject of litigation related to the 2008 Budget Act. On September 30, 2009 the State Supreme Court denied review of an adverse Court of Appeal decision in *Shaw v. Chiang*, which invalidated the use of these funds as appropriated. Consequently, these fuels sales taxes were retained in the Public Transportation Account for appropriation. These funds are “borrowable” for short-term General Fund cash needs. Chapters 11 and 12, Statutes of 2010, were passed in the special session providing General Fund relief by eliminating the state sales tax on gas and increasing the state gas excise tax by a like amount. This effectively eliminates funding subject to the provisions of Proposition 42 and significantly reduces the funding going into the Public Transportation Account, eliminating the so-called spillover allocation. Fuel excise tax revenues will be used to offset highway bond debt service thus providing increasing General Fund relief beginning in fiscal year 2009-10 and growing in future years. (Approximately \$603 million of relief is projected for fiscal year 2010-11.) Remaining Public Transportation Account funds and new diesel sales tax revenues are used to offset transit bond debt service allowable under the court ruling in fiscal years 2009-10 and 2010-11. After these two fiscal years, the statute

provides for no further use of Public Transportation Account for debt service offset. Additionally, \$650 million of excise tax proceeds available from this legislation in fiscal year 2010-11 is proposed to be lent to the General Fund. This funding is available without diminishing previously anticipated transportation program levels and will be repaid in three years.

The special session transportation legislation provides for ongoing highway and local road funding similar in distribution to the former provisions that governed Proposition 42 funds (sales tax on gasoline). Increased funding is provided for the State Highway Operations and Protection Program (highway safety and rehabilitation projects, primarily) as well as local streets and roads and the State Transportation Improvement Program (capacity projects, primarily). The legislation provides approximately \$350 million in ongoing annual transit operations grants with a one-time appropriation of \$400 million for the remainder of fiscal years 2009-10 and 2010-11. Two initiatives have been submitted for the November 2010 ballot which, if either is approved, limit the ability of the state to implement the transportation legislation. See “THE BUDGET PROCESS – Proposed November 2010 Initiatives - Local Government Funds” and “-Increases in Taxes or Fees.”

9. Budget Stabilization Account – Pursuant to Proposition 58, the state normally would be required to set aside a specified portion of estimated annual General Fund revenues for fiscal year 2009-10 in the BSA for reserves that may be used to offset future shortfalls in the General Fund. Given the magnitude and urgency of the state’s ongoing financial stress, in accordance with Proposition 58, the Amended 2009 Budget Act suspended the transfer to the BSA for fiscal year 2009-10.
10. Prison Funding – The Amended 2009 Budget Act included \$7.9 billion in General Fund expenditures for the California Department of Corrections and Rehabilitation (“CDCR”). In arriving at this figure, a total of \$1.2 billion of savings for CDCR operations was assumed. Due to the delay in passage of legislation, and the failure of the Legislature to adopt certain prison and parole reforms requested by the Governor, actual savings were approximately \$587 million, with the result that CDCR costs were approximately \$613 million higher than assumed in the Amended 2009 Budget Act, not including any changes as of the 2010-11 May Revision. As of the 2010-11 May Revision, CDCR costs in fiscal year 2009-10, excluding debt service and savings from employee compensation, are projected to exceed the level included in the Amended 2009 Budget Act by \$906.6 million.

Fiscal Year 2009-10 Revised Estimates in the 2010-11 May Revision

The 2010-11 May Revision revised various revenue and expenditures estimates for fiscal year 2009-10. The 2010-11 May Revision projects, based on the various assumptions and proposals it contains, that the state will end fiscal year 2009-10 with a negative reserve of \$6.8 billion, compared to the estimate of a negative \$5.4 billion reserve at the time of the 2010-11 Governor’s Budget.

The 2010-11 May Revision reflects a net increase of \$493.1 million in General Fund beginning balance at the start of fiscal year 2009-10, since the 2010-11 Governor’s Budget. This change in the starting balance is primarily due to the following components:

- \$317.4 million increase in prior year Corporate Income Tax accruals;
- \$184.1 million increase in fiscal year 2008-09 Proposition 98 savings;

As of the 2010-11 May Revision, General Fund revenues and transfers for fiscal year 2009-10 are projected at a revised \$86.5 billion, a decrease of \$1.563 billion compared with the 2010-11 Governor's Budget estimates. This change is primarily made up of the following components:

- \$2.619 billion decrease in personal income tax;
- \$816 million increase in sales and use tax;
- \$240 million increase in other revenues and transfers ;

Under the 2010-11 May Revision, General Fund expenditures for fiscal year 2009-10 are projected at \$86.5 million, an increase of \$373 million compared with the 2010-11 Governor's Budget estimates. This increase in expenditures is primarily attributable to an increase in Proposition 98 expenditures of \$1.2 billion, and a decrease in non-Proposition 98 expenditures of \$803.3 million. The increase in Proposition 98 expenditures is primarily due to a decrease in Proposition 1A and RDA offset.

The Non-Proposition 98 expenditure decrease is due primarily to the combined effects of an \$814 million increase in Health and Human Services expenditures, a decrease of \$367.9 million in borrowing costs, increased Federal Funds Offsets of \$430.5 million, and an increase in Proposition 1A and RDA offsets of \$890.2 million (previously budgeted as offset to Proposition 98 expenditures).

Budget Risks

The Amended 2009 Budget Act was based on a variety of assumptions. As described above, actual circumstances or conditions in fiscal year 2009-10 to date have differed from such assumptions in material respects, and circumstances and conditions for the balance of fiscal year 2009-10 may differ from those assumptions, and the state's financial condition may continue to be adversely impacted. See "STATE FINANCIAL PRESSURE" and "AMENDED 2009 BUDGET ACT."

Budget risks still remaining for the 2009-10 fiscal year include, but are not limited to, the following:

- Actual revenues through the end of fiscal year 2009-10 may be below projected amounts.
- Delays in or inability of the state to implement budget solutions, or increased costs, as a result of litigation. The following cases dealing with elements of the Amended 2009 Budget Act are still pending:
 - There are almost three dozen separate cases dealing with the Governor's furlough of state employees (\$1.3 billion potential General Fund impact) (see "LITIGATION – Budget-Related Litigation Actions Regarding Furlough of State Employees"). The State Supreme Court has granted review of several cases, and several others are pending before the Court of Appeal. (In March 2010, the Legislature passed legislation exempting from furlough state workers paid from sources other than the General Fund. The Governor vetoed this bill.);
 - Potential court orders for the state to expend moneys for prison healthcare improvements, in excess of the amounts included in the Amended 2009 Budget Act. See "STATE FINANCES – Department of Corrections and Rehabilitation" and "LITIGATION – Prison Healthcare Reform and Reduction of Prison Population."

Although appeals are continuing, the Governor has prevailed at lower court levels on several cases challenging aspects of the Amended 2009 Budget Act, including his vetoes of appropriations in July 2009, and the transfer of redevelopment agency moneys.

New Revenues

The Amended 2009 Budget Act included several major changes in General Fund revenues described below. The Amended 2009 Budget Act did not include any additional tax increases over those provided for pursuant to the Initial 2009 Budget Act, though it did include certain tax law changes intended to increase tax compliance and accelerate some revenues that were not in the Initial 2009 Budget Act.

As part of the Initial 2009 Budget Act passed in February 2009, the following tax and fee increases were adopted:

- Temporary Sales Tax Increase: Effective April 1, 2009, the General Fund sales and use tax rate was temporarily increased by 1 cent, from 5 percent to 6 percent. This tax increase will be in effect through June 30, 2011. As of the 2010-11 May Revision, this tax law change is expected to generate additional sales tax revenues of \$4.299 billion in fiscal year 2009-10 and \$4.223 billion in fiscal year 2010-11 for the General Fund.
- Vehicle License Fees: Effective May 19, 2009, vehicle license fees were temporarily increased from 0.65 percent to 1.15 percent with 0.35 percent going to the General Fund and 0.15 percent going to the Local Safety and Protection Account for local law enforcement grant programs previously funded from the General Fund. Vehicle license fees apply to the value of the vehicle (initially its market value and then subject to a standard depreciation schedule). This increase will remain in effect through June 30, 2011. As of the 2010-11 May Revision, this law change is expected to generate additional revenues of approximately \$1.386 billion in fiscal year 2009-10 and \$1.472 billion in fiscal year 2010-11.
- Personal Income Tax Surcharge: The Initial 2009 Budget Act provided for a temporary addition of 0.25 percent to each personal income tax rate for tax years 2009 and 2010. As of the 2010-11 May Revision, this change is expected to generate approximately \$2.707 billion of additional General Fund revenues in fiscal year 2009-10 and \$1.073 billion in fiscal year 2010-11.
- Dependent Exemption Credit Reduction: The Initial 2009 Budget Act included a temporary reduction in the Personal Income Tax-exemption credit for dependents to the amount provided for the personal credit for tax years 2009 and 2010 from \$309 to \$99 (tax year 2008 values). As of the 2010-11 May Revision, this change is expected to generate approximately \$1.429 billion of additional General Fund revenues in fiscal year 2009-10 and \$700 million in fiscal year 2010-11.

The Amended 2009 Budget Act, passed in July 2009, included tax law changes affecting the General Fund as described below:

- Non-Retailer Registration for Use Tax: Under current law, non-retailers – those who do not sell tangible personal property – are not required to register with the Board of Equalization (“BOE”). This law change will require non-retailers that hold a business license and have at least \$100,000 in gross receipts to register with the BOE and submit a return that details purchases made during the year that were subject to the use tax yet for which no use tax was paid. This law change is expected to increase General Fund sales and use tax revenue by \$26 million in fiscal year 2009-10 and \$123 million in fiscal year 2010-11, with increasing amounts thereafter.

- Accelerate Estimated Tax Payments: Under current law in 2009, individuals and corporations are required to pay 30 percent each with the first two estimated payments, and 20 percent each for the last two estimated payments. Under this law change, beginning with the 2010 tax year, the first quarter estimated payment percentage will remain at 30 percent payable on April 15, the second quarter will increase to 40 percent payable on June 15, the third estimated payment will be eliminated, and the fourth quarter estimated payment will increase from 20 percent to 30 percent payable on December 15 for corporations and January 15 for individuals. As of the 2010-11 May Revision, this law change is expected to accelerate \$1.295 billion into fiscal year 2009-10 (\$672 million in personal income tax receipts and \$623 million in corporate tax receipts) and \$98 million in fiscal year 2010-11 (\$60 million in personal income tax receipts and \$38 million in corporate tax receipts).
- Accelerate Wage Withholding: This tax law change increased current wage withholding rates by 10 percent and, as of the 2010-11 May Revision, is expected to accelerate \$1.6 billion of personal income tax receipts into fiscal year 2009-10.
- Require Backup Withholding: Under current federal law, gambling winnings reported on Internal Revenue Service (“IRS”) Form W2G and payments made by banks and businesses reported on various IRS 1099 forms may be subject to backup withholding on those payments. Payments reported on IRS 1099 forms include payments to independent contractors, rents, commissions, and royalty payments. This law change will conform state law to federal law by requiring a withholding rate of 7 percent for state purposes whenever it is required for federal purposes. As of the 2010-11 May Revision, this law change is expected to increase personal income tax revenues by \$32 million in fiscal year 2009-10 followed by an additional \$31 million in fiscal year 2010-11.

State Office Building Sales Program.

Pursuant to legislation enacted in 2009, the Department of General Services (DGS) has solicited proposals for the disposition of 11 state office properties, through a sale, lease, or a sale with an option to lease back. A large number of bids were received in April 2010 and the Department of General Services is still conducting due diligence on the bids received. Once a preferred buyer has been identified, DGS will notify the Legislature. Under current law, the Legislature has 30 days to review the sales agreement, but a bill adopted unanimously by the Assembly on June 3, 2010 (AB 2605) would require affirmative Legislative approval for the building sale to proceed. This bill is pending in the Senate. At this time the amount of potential revenue from the proposed sale is unknown. The 2010-11 May Revision assumes approximately \$600 million of one-time net revenues to the General Fund over the next three years from the sale. (Approximately \$1.1 billion of other sale proceeds would have to retire existing debt used to construct some of the buildings.)

Set forth below is a table showing the estimated General Fund Budget Summary for fiscal year 2009-10 as of the Amended 2009 Budget Act, as originally projected by the 2010-11 Governor’s Budget, and as subsequently revised by the 2010-11 May Revision.

TABLE 5
2009-10 Estimated General Fund Budget Summary
(Dollars in Millions)

	As of Amended 2009 Budget Act (July 28, 2009)	As of 2010-11 Governor's Budget (January 8, 2010)	As of 2010-11 May Revision (May 14, 2010)
Prior Year Resources Available	\$(3,379) ^(a)	\$(5,855) ^(a)	\$(5,361) ^(a)
Revenues and Transfers	89,541	88,084	86,521
Expenditures	84,583	86,092	86,465
Fund Balance	<u>\$1,579</u>	<u>\$(3,863)</u>	<u>\$(5,305)</u>
Reserve for Liquidation of Encumbrances	\$1,079	\$1,537	\$1,537
Special Fund for Economic Uncertainties	\$500	\$(5,400)	\$(6,842)
Budget Stabilization Account	--	--	--
Total Available Reserve	\$500	\$(5,400)	\$(6,842)

^(a) Includes a carry-over adjustment of \$1.09 billion from amnesty-related payments, of which \$710 million will have to be refunded or will reduce revenues in future years, including a \$200 million adjustment in fiscal year 2009-10 and a \$510 million adjustment in fiscal year 2010-11 and 2011-12.

Source: State of California, Department of Finance.

CASH MANAGEMENT

Cash Management Tools

General. The majority of the state's General Fund revenues are received in the latter part of the fiscal year. Expenditures from the General Fund occur more evenly throughout the fiscal year. The state's cash flow management program customarily addresses this timing difference by making use of internal borrowing (see "– Internal Borrowing") and by issuing short-term notes in the capital markets (see "– External Borrowing"). External borrowing is typically done with RANs that are payable not later than the last day of the fiscal year in which they are issued. RANs have been issued in 22 of the last 23 fiscal years and have always been paid at maturity. The state also is authorized under certain circumstances to issue RAWs that are payable in the succeeding fiscal year. The State issued RAWs to bridge short-term cash flow shortages in 1992, 1993, 1994, 2002 and 2003. See "STATE FINANCES - State Warrants – Reimbursement Warrants" for more information on RAWs.

RANs and RAWs are both payable from any "Unapplied Money" in the General Fund of the state on their maturity date, subject to the prior application of such money in the General Fund to pay Priority Payments. "Priority Payments" are payments as and when due to: (i) support the public school system and public institutions of higher education (as provided in Section 8 of Article XVI of the State Constitution); (ii) pay principal of and interest on general obligation bonds and general obligation commercial paper notes of the state; (iii) reimburse local governments for certain reductions in ad valorem property taxes (as required by Section 25.5 of Article XIII of the State Constitution), or make required payments for borrowings secured by such repayment obligation (see "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Obligations in Connection with Proposition 1A of 2004"); (iv) provide reimbursement from the General Fund to any special fund or account to the extent such reimbursement is

legally required to be made to repay borrowings therefrom pursuant to California Government Code Sections 16310 or 16418; and (v) pay state employees' wages and benefits, state payments to pension and other state employee benefit trust funds, state Medi-Cal claims, lease payments to support lease-revenue bonds, and any amounts determined by a court of competent jurisdiction to be required by federal law or the State Constitution to be paid with state warrants that can be cashed immediately. See "STATE FINANCES - State Warrants."

The state has employed additional cash management measures during some fiscal years; all of the following techniques were used during fiscal year 2008-09 and so far during fiscal year 2009-10:

- The State Controller has delayed certain types of disbursements from the General Fund.
- Legislation has been enacted during the fiscal year increasing the state's internal borrowing capability, and the state has increased the General Fund's internal borrowings.
- Legislation has been enacted deferring some of the state's disbursements until later in the fiscal year, when more cash receipts are expected, or into the succeeding fiscal year.

In addition, as noted below, the state issued registered warrants in July and August 2009 because of insufficient cash resources. See " – Cash Management in Fiscal Year 2009-10."

Internal Borrowing. The General Fund is currently authorized by law to borrow from more than 700 of the state's approximately 1,300 other funds in the State Treasury (the "Special Funds"). Total borrowing from Special Funds must be approved by the PMIB. The Controller submits an authorization request to the PMIB quarterly, based on forecasted available funds and borrowing needs. The Legislature may from time to time adopt legislation establishing additional authority to borrow from Special Funds. The state has historically made extensive use of its internal borrowing capability to provide cash resources to the General Fund.

One fund from which moneys may be borrowed to provide additional cash resources to the General Fund is the BSA, a reserve fund established in 2004 by Proposition 58. However, during fiscal year 2009-10, there are no funds available in the BSA. The state also may transfer funds into the General Fund from the state's SFEU, which is not a Special Fund. See "STATE FINANCES – Inter-Fund Borrowings" for a further description of this process.

External Borrowing. As noted above, issuance of RANs is a normal part of the state's annual cash flow management program. On September 29, 2009, the state issued \$8.8 billion of RANs which matured in May and June 2010. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Cash Flow Borrowings."

Payment Deferrals. From time to time, the Legislature changes by statute the due date for various payments, including those owed to public schools, universities and local governments, until a later date in the fiscal year, or even into the following fiscal year, in order to more closely align the state's revenues with its expenditures. This technique has been used several times through the enactment of budget bills in fiscal years 2008-09 and 2009-10. Some of these statutory deferrals were made permanent, and others were implemented only for one fiscal year. One effect of these deferrals has been to reduce the state's need for external borrowing to bridge its cash flow deficit during the fiscal year.

In addition, state law gives the State Controller some flexibility as to how quickly the state must pay its bills. For instance, income tax refunds for personal income taxes are not legally due until 45 days after the return filing deadline, which is normally April 15. Accordingly, while the state has typically paid tax refunds as returns are filed, it can conserve cash by withholding refund payments until after the

April 15 due date. Payments to vendors generally must be made within 45 days of receipt of an invoice. The state may delay payment until the end of this period, or it may even choose to make these payments later and pay interest. These delays are only used if the State Controller foresees a relatively short-term cash flow shortage. Such an instance occurred in February 2009, when the State Controller delayed making about \$2.9 billion of tax refunds, and another \$1.3 billion of vendor and other payments. Enactment of budget solutions in February 2009 allowed all the delayed payments to be made up in March 2009.

On March 1, 2010 the Governor signed a bill to provide additional cash management flexibility to state fiscal officials (Chapter 1, Statutes of 2009-10 Eighth Extraordinary Session, the “cash management bill”). The cash management bill authorizes the Controller to delay making payments during March 2010 totaling about \$1.1 billion for several programs, including higher education, trial court operations (but not payroll) and contribution to the State Teachers’ Retirement System (STRS). All such deferrals are to be repaid between April 15 and May 1, 2010.

The cash management bill also authorizes deferral of certain payments during fiscal year 2010-11 including payments to K-12 schools (not to exceed \$2.5 billion in the aggregate at any one time), SSI/SSP reimbursements to the federal government, certain local government social services, transportation payments and Proposition 63 mental health payments (not to exceed \$1 billion in the aggregate at one time), higher education, STRS payment modifications and trial operations (not including payroll). Many of these deferrals may be made in July 2010, October 2010 and March 2011, not to exceed 60, 90 and 60 days, respectively. However, depending on actual cash flow conditions at the time, the Controller, Treasurer and Director of Finance may either accelerate or delay the deferrals up to 30 days, or reduce the amounts deferred. In total, as of the 2010-11 May Revision, the Department of Finance estimates these deferrals will improve the state’s cash position by up to \$4.8 billion in certain months, thereby reducing the need for external cash management borrowing or other measures. Certain small cities and counties, community college districts and school districts that can demonstrate hardship, will not be subject to these deferrals. The cash management bill expressly provides that no deferrals may affect state payroll or payments of debt service on state bonds, lease rental payments which support revenue bonds, or certain other payments which are used to support debt service.

Cash Management in Fiscal Year 2009-10

The state entered fiscal year 2009-10 on July 1, 2009 with severely depleted cash resources as a result of having to pay significant obligations before June 30, 2009, including repayment of \$5.5 billion of RANs issued in fiscal year 2008-09. In addition, significant payments to public schools had been deferred from the end of fiscal year 2008-09 into the first few weeks of July 2009. The state had projected in May 2009 that revenues would be lower than expected and that it faced a \$22 billion budget gap. However, by July 1, 2009, additional budget solutions for fiscal year 2009-10 had not been adopted.

Faced with reduced cash resources, as described above, the State Controller started to issue registered warrants (or IOUs) on July 2, 2009, for certain obligations of the state not having payment priority under law. The State Controller was able to manage cash resources, as described above, to ensure that higher priority payments, such as for schools and debt service, were made on time in July and August 2009. On July 28, 2009, the Governor signed the Amended 2009 Budget Act, which included a number of provisions for cash management purposes.

With the adoption of the Amended 2009 Budget Act, the state was able to undertake its normal external borrowing program for fiscal year 2009-10. In order to provide an immediate increase in cash resources, the state issued \$1.5 billion of 2009 Interim RANs (the “Interim Notes”) on August 27, 2009, which were scheduled to mature on October 5, 2009. This permitted early redemption of the outstanding

registered warrants (\$2.6 billion) as of September 4, 2009. (The Interim Notes were subsequently repaid in full on September 29, 2009 with a portion of the proceeds of the 2009-10 Series A Notes.)

The 2010-11 May Revision projected that the state would have sufficient cash resources to repay all of its \$8.8 billion of 2009-10 Series A Notes in June of 2010 as scheduled, and they were all retired as of June 23, 2010. Cash flow projections prepared following the 2010-11 May Revision show an available balance of cash and unused borrowable resources at June 30, 2010 of about \$6.2 billion, after repayment of the RANs. In late January 2010, the State Controller issued a report projecting a small negative cash balance (under \$200 million) on or about April 1, 2010. Reports of cash receipts for the months of January, February and March 2010 showed improved cash balances, and the Department of Finance, State Controller's Office, and State Treasurer's Office worked together to manage cash resources through the early April 2010 period by identifying additional borrowable resources and obtaining legislative approval for certain cash deferrals as described above under "Payment Deferrals." Although cash receipts for the month of April 2010 were \$3.6 billion below projections (partly offset by May 2010 cash receipts which were \$500 million above projections), the Controller's Office expects to have an adequate cushion of cash resources through the balance of fiscal year 2009-10.

Cash Management in Fiscal Year 2010-11

The State Controller issued a report on June 2, 2010, based on revenue and spending estimates from the 2010-11 May Revision and actual cash receipts and expenditures through April 30, 2010, containing cash projections for the remainder of the 2010 calendar year. The report contains two separate projections, one assuming a timely adopted budget including solutions equivalent to those in the 2010-11 May Revision, and another assuming a budget adopted on October 1. Although a late budget would ultimately reduce the budgetary benefit of any solutions, as a cash matter it would have the positive effect of limiting certain expenditures early in the fiscal year. The report therefore projects that in either scenario, the state will maintain a prudent cash cushion through July and August 2010. Cash flow projections prepared following the 2010-11 May Revision assume external borrowing of \$10 billion in August 2010 (assuming a budget has been adopted in a timely manner), although the Department of Finance notes that this number will be subject to further refinement as the terms of a budget act for fiscal year 2010-11 are finalized.

The Controller's report notes that the state's relatively positive projected cash position in the early months of fiscal year 2010-11 is not indicative of a return to fiscal health. Rather, the state's cash position has improved as a result of (1) the cash deferral legislation passed in March 2010, described above under "Payment Deferrals" and (2) continued heavy reliance on internal borrowing by the General Fund from various Special Funds. The Controller also notes that while the state is not projected to run out of cash until the end of September 2010, in the absence of budgetary solutions, corrective action will be required before the cash resources are depleted. The Controller's report indicates that one such corrective action could be the issuance of IOUs. The Department of Finance will continue to work with the State Controller's Office and the State Treasurer's Office to develop any additional cash solutions which may be necessary if adequate budget and cash solutions cannot be adopted in a timely manner by the start of fiscal year 2010-11.

STATE INDEBTEDNESS AND OTHER OBLIGATIONS

General

The State Treasurer is responsible for the sale of most debt obligations of the state and its various authorities and agencies. The state has always paid when due the principal of and interest on its general obligation bonds, general obligation commercial paper notes, lease-revenue obligations and short-term obligations, including RANs and RAWs. Additional information regarding the state's long-term debt appears in the section "STATE DEBT TABLES."

Capital Facilities Financing

General Obligation Bonds

The State Constitution prohibits the creation of general obligation indebtedness of the state unless a bond measure is approved by a majority of the electorate voting at a general election or a direct primary. General obligation bond acts provide a continuing appropriation from the General Fund of all debt service payments on general obligation bonds, subject only to the prior application of moneys in the General Fund to the support of the public school system and public institutions of higher education. Under the State Constitution, the appropriation to pay debt service on the general obligation bonds cannot be repealed until the principal and interest on the bonds has been paid. See “STATE FINANCES - State Expenditures.” Certain general obligation bond programs, called “self-liquidating bonds,” receive revenues from specified sources so that moneys from the General Fund are not expected to be needed to pay debt service, but the General Fund is liable as a back-up if the specified revenue source is not sufficient. The principal self-liquidating bond programs are the ERBs, supported by a special sales tax, and veterans general obligation bonds, supported by mortgage repayments from housing loans made to military veterans. See “ – Economic Recovery Bonds.”

General obligation bonds are typically authorized for infrastructure and other capital improvements at the state and local level. Pursuant to the state Constitution, general obligation bonds cannot be used to finance state budget deficits (except as already authorized by ERBs, as described below).

As of May 1, 2010, the state had outstanding \$78,439,139,000 aggregate principal amount of long-term general obligation bonds, of which \$68,917,429,000 were payable primarily from the state’s General Fund, and \$9,521,710,000 were “self-liquidating” bonds payable first from other special revenue funds. As of May 1, 2010, there were unused voter authorizations for the future issuance of \$42,909,259,000 of long-term general obligation bonds, some of which may first be issued as commercial paper notes (see “General Obligation Commercial Paper Program” below). Of this unissued amount, \$1,331,210,000 is for general obligation bonds payable first from other revenue sources. See the table “Authorized and Outstanding General Obligation Bonds” following the caption “STATE DEBT TABLES.”

Legislation enacted November 4, 2009 authorizes submission to the voters at the statewide election on November 2, 2010 of a ballot measure to approve the issuance of \$11.14 billion in general obligation bonds for a wide variety of purposes relating to improvement of California’s water supply systems, drought relief, and groundwater protection. The bill specifies that not more than one-half of the bonds may be sold before July 1, 2015. Additional bond measures may be included on the November 2, 2010 election ballot.

Variable Rate General Obligation Bonds

The general obligation bond law permits the state to issue as variable rate indebtedness up to 20 percent of the aggregate amount of long-term general obligation bonds outstanding. As of May 1, 2010, the state had outstanding \$5,294,440,000 principal amount of variable rate general obligation bonds (which includes a portion of the ERBs described below), representing about 6.7 percent of the state’s total outstanding general obligation bonds as of that date. These bonds are described generally in the following table:

Name of Bond	Outstanding Principal Amt (\$000) as of May 1, 2010	Variable Type	Liquidity Support ^(a)	Other Information
General Obligation	\$2,671,790	Daily/Weekly Floating Rate	Letters of Credit	
General Obligation	\$1,047,880	Fixed Rate to Mandatory Tender Dates	None	Mandatory Tenders in April 2012, November 2012 and April 2013
ERB	\$1,074,770	Daily/Weekly Floating Rate	Letters of Credit and Standby Purchase Agreements	\$422,375,000 insured by FSA
ERB	\$500,000	Fixed Rate to Mandatory Tender Dates	None	Mandatory Tender on July 1, 2014

^(a) See "Bank Arrangements."

Source: State of California, Office of the State Treasurer.

Under state law, except for the ERBs, the state must pay the principal of any general obligation bonds which are subject to optional or mandatory tender, and which are not remarketed or, if applicable, purchased by financial institutions which provide liquidity support to the state. The state has not entered into any interest rate hedging contracts in relation to any of its variable rate general obligation bonds, and it no longer has any auction rate bonds outstanding.

General Obligation Commercial Paper Program

Pursuant to legislation enacted in 1995, voter-approved general obligation indebtedness may be issued either as long-term bonds or, for some but not all bond issues, as commercial paper notes. Commercial paper notes may be renewed or may be refunded by the issuance of long-term bonds. It is currently the state's policy to use commercial paper notes to provide flexibility for bond programs, such as to provide interim funding of voter-approved projects and to facilitate refunding of variable rate bonds into fixed rate bonds. Prior to late 2008, commercial paper notes were used primarily to repay internal loans from the state's Pooled Money Investment Account ("PMIA"), as a step toward issuance of long-term bonds. However, the internal loan program is no longer being used for general obligation bond programs and all such loans have been repaid from sale of long-term general obligation bonds. Pursuant to the terms of the bank credit agreement presently in effect, the general obligation commercial paper program may have up to \$2 billion in aggregate principal amount at any time. This maximum amount may be increased or decreased in the future. As of May 7, 2010, \$1,292,170,000 aggregate principal amount of general obligation commercial paper notes were outstanding, most of which relates back to retirement of PMIA loan expenditures in 2008. Commercial paper notes are not included in the calculation of permitted variable rate indebtedness described under "Variable Rate General Obligation Bonds."

Bank Arrangements

In connection with the letters of credit or other credit facilities obtained by the state in connection with variable rate obligations and the commercial paper program, the state has entered into a number of reimbursement agreements or other credit agreements with a variety of financial institutions as set forth in the table titled "BANK ARRANGEMENTS" which immediately follows the end of the text of this APPENDIX A, prior to "STATE DEBT TABLES." These agreements include various representations

and covenants of the state, and the terms (including interest rates and repayment schedules) by which the state would be required to repay any drawings (including drawings resulting from any failed remarketings) on the respective letters of credit or other credit enhancement to which such credit agreements relate. To the extent that any variable rate obligations cannot be remarketed over an extended period (whether due to reductions in the credit ratings of the institution providing credit enhancement or other factors), interest payable by the state pursuant to the reimbursement agreement or credit agreement would generally increase over current market levels relating to the variable rate obligations, and the principal repayment period would generally be shorter (typically less than five years) than the repayment period otherwise applicable to the variable rate obligation. On occasion the state's variable rate obligations have not been remarketed resulting in draws on the applicable credit facilities.

During 2009, the state took a number of actions regarding its bank credit arrangements, including extending existing letter of credit facilities and converting standby purchase agreements to letters of credit for some of its floating rate ERBs and for its Commercial Paper program. The makeup of some of the state's credit facilities was also revised with the deletion or substitution of banks. The state faces the need to renew about \$1.37 billion of letters of credit for several series of variable rate general obligation bonds, in November and December 2010. See the "BANK ARRANGEMENTS" table at the end of APPENDIX A, preceding the "STATE DEBT TABLES."

Lease-Revenue Obligations

In addition to general obligation bonds, the state has acquired and constructed capital facilities through the use of lease-revenue borrowing (also referred to as lease-purchase borrowing). Under these arrangements, the State Public Works Board, another state or local agency or a joint powers authority issued bonds to pay for the construction of facilities such as office buildings, university buildings, courthouses or correctional institutions. These facilities are leased to a state agency, the California State University, the University of California or the Judicial Council under a long-term lease that provides the source of payment of the debt service on the lease-revenue bonds. In some cases, there was not a separate bond issue, but a trustee directly created certificates of participation in the state's lease obligation, which were then marketed to investors. Under applicable court decisions, such lease arrangements do not constitute the creation of "indebtedness" within the meaning of the State Constitutional provisions that require voter approval. For purposes of this APPENDIX A and the tables under "STATE DEBT TABLES," the terms "lease-revenue obligation," "lease-revenue financing," "lease-purchase obligation" or "lease-purchase" means principally bonds or certificates of participation for capital facilities where the lease payments providing the security are payable from the operating budget of the respective lessees, which are primarily, but not exclusively, derived from the General Fund, and also includes revenue bonds for a state energy efficiency program secured by payments made by various state agencies under energy service contracts. The state had \$10,071,627,519 in lease-revenue obligations outstanding as of May 1, 2010. The tables under "STATE DEBT TABLES" do not include equipment leases or leases which were not sold, directly or indirectly, to the public capital markets. The State Public Works Board, which is authorized to sell lease-revenue bonds, had \$9,834,701,000 authorized and unissued as of May 1, 2010. See "STATE FINANCES – Department of Corrections and Rehabilitation – Prison Construction Program."

Non-Recourse Debt

Certain state agencies and authorities issue revenue obligations for which the General Fund has no liability. Revenue bonds represent obligations payable from state revenue-producing enterprises and projects, which are not payable from the General Fund, and conduit obligations payable only from revenues paid by private users of facilities financed by the revenue bonds. The enterprises and projects include transportation projects, various public works projects, public and private educational facilities (including the California State University and University of California systems), housing, health facilities

and pollution control facilities. State agencies and authorities had approximately \$56 billion aggregate principal amount of revenue bonds and notes which are non-recourse to the General Fund outstanding as of December 31, 2009, as further described in the table “State Agency Revenue Bonds and Conduit Financing” under “STATE DEBT TABLES.”

Build America Bonds

In February 2009, the Congress enacted certain new municipal bond provisions as part of the ARRA (stimulus bill). One provision allows municipal issuers such as the state to issue “Build America Bonds” (“BABs”) for new infrastructure investments. BABs are bonds whose interest is subject to federal income tax, but the U.S. Treasury will repay to the state an amount equal to 35 percent of the interest cost on any BABs issued during 2009 and 2010. This results in a net interest expense lower than what the state would have had to pay for tax-exempt bonds of similar maturity. The subsidy payments from general obligation bonds are General Fund revenues to the state, while subsidy payments for lease-revenue bonds are deposited into a fund which is made available to the State Public Works Board for any lawful purpose. In neither instance are the subsidy payments specifically pledged to repayment of the BABs to which they relate. The cash subsidy payment with respect to the BABs, to which the state is entitled, is treated by the Internal Revenue Service as a refund of a tax credit and such refund may be offset by the Department of the Treasury by any liability of the state payable to the federal government, including in respect of any internal revenue tax (including any interest and penalties), past due child support, past due and legally enforceable debt due federal agencies, unemployment compensation debts, and past due legally enforceable state income tax debts.

Starting in April 2009 and through April 30, 2010, the state has issued a significant amount of BABs, including \$10.39 billion of general obligation bonds and \$551 million of lease-revenue bonds. The aggregate amount of the subsidy payments to be received from fiscal year 2010-11 through the maturity of these bonds (mostly 20 to 30 years) is approximately \$7.46 billion for the general obligation BABs and \$338 million for the lease-revenue BABs. The Obama Administration has proposed making the BABs program permanent, although at a lower subsidy rate for future issuances. In late May 2010 the House of Representatives passed a bill (H.R. 4213) which extends the BAB program for two years, at successively lower subsidy rates, but higher than what was proposed by the Obama Administration; this proposal has not yet been acted on by the Senate.

Future Issuance Plans; General Fund Debt Ratio

Between November 2006 and August 2009, voters and the Legislature authorized more than \$60 billion of new general obligation bonds and lease-revenue bonds. This new authorization substantially increased the current amount of such General Fund-supported debt outstanding to more than \$79 billion, while still leaving authorized and unissued about \$51 billion of such bonds as of May 1, 2010. In order to address the expenditure needs for these new authorizations, along with those which existed before 2006, the state has increased the volume of issuance of both of these categories of bonds substantially, compared to previous years, starting in fiscal year 2007-08. The amounts and timing of future issuance of general obligation and lease-revenue bonds will depend on a variety of factors, including the actual timing of expenditure needs for the various programs for which such bonds are to be issued, the amount and timing of interim financing provided to the programs, the interest rate and other market conditions at the time of issuance, and the timing and amounts of additional general obligation bonds or lease-revenue bonds that may be approved.

Disruptions in financial markets and uncertainties about the state’s budget condition caused significant disruptions in the state’s bond issuance program during fiscal year 2008-09. Because of these factors, the state did not issue any new general obligation bonds between July 2008 and March 2009. In March 2009, it issued \$6.54 billion of new tax-exempt bonds, the largest new money general obligation

bond issue in the state's history (excluding ERBs). A few weeks later, the state took advantage of the new federal rules to issue \$6.86 billion of federally taxable general obligations bonds, of which \$5.3 billion were BABs. A significant part of the over \$13 billion of bonds issued in the spring of 2009 was used to retire internal borrowings used to fund construction projects, which had built up because of the long hiatus in bond issuance. An additional \$6.546 billion of tax-exempt and taxable general obligation bonds (\$2.66 billion BABs) were issued in the fall of 2009, together with \$1.549 billion of lease-revenue bonds (\$250 million BABs).

The combination of unusual circumstances resulted in public offerings of a record \$19.7 billion of general obligation bonds during calendar year 2009. Through May 31, 2010, the state has issued \$5.9 billion of general obligation bonds and \$721 million of lease-revenue bonds in calendar year 2010. The 2010-11 May Revision projects issuance of about \$15.8 billion of general obligation and lease-revenue bonds in that fiscal year. These are preliminary estimates, and the actual amount of bonds sold for the balance of fiscal year 2009-10 and in fiscal year 2010-11 will depend on many factors, including more detailed review of program needs, budget priorities and market conditions.

Based on the current Department of Finance projections of program expenditure needs, without taking into account any future authorizations which may occur, the State Treasurer has estimated that the aggregate amount of outstanding debt supported by the General Fund, including general obligation, lease-revenue, and Proposition 1A bonds, based on current voter and legislative authorizations, is estimated to peak at approximately \$111.3 billion by fiscal year 2014-15, compared to the current outstanding amount of about \$80.8 billion. The annual debt service costs on this amount of debt is estimated by the State Treasurer to increase to approximately \$9.93 billion in fiscal year 2012-13 compared to about \$6.09 billion budgeted in fiscal year 2009-10. The projected amounts for fiscal year 2010-11 through 2011-12 include the interest, and for fiscal year 2012-13, the interest and principal payable on the \$1.90 billion of bonds issued in connection with Proposition 1A of 2004. (See "Obligations in Connection with Proposition 1A of 2004.") After fiscal year 2012-13, projected peak debt service is \$9.97 billion in fiscal year 2017-18. (These estimates do not include ERBs, described below, or veterans general obligation bonds supported by mortgage repayments from housing loans made to military veterans, nor do they take into account potential benefits from future refunding opportunities.)

In light of the substantial drop in General Fund revenues since fiscal year 2007-08, described elsewhere in this APPENDIX A, and the projections of substantial new bond sales in the future, the ratio of debt service on general obligation, lease-revenue, and the Proposition 1A bonds supported by the General Fund, to annual General Fund revenues and transfers (the "General Fund Debt Ratio"), can be expected to increase significantly in future years. Based on the revised estimates contained in the 2010-11 May Revision, in fiscal year 2009-10, the General Fund Debt Ratio is estimated to equal approximately 7.03 percent. Based on the assumed debt issuance referred to in the preceding paragraph, and the assumed growth in General Fund revenues and transfers contained in the 2010-11 May Revision, through fiscal year 2013-14, the state's General Fund Debt Ratio is projected to peak at 10.58 percent in fiscal year 2012-13, the year in which the Proposition 1A bonds mature. In the fiscal year following the maturity of the Proposition 1A bonds, fiscal year 2013-14, the state's General Fund Debt Ratio is projected to decline to 9.34 percent. The state's General Fund Debt Ratio after fiscal year 2013-14 will depend on the state's future General Fund revenues which will in turn depend on a variety of factors including but not limited to economic, population and inflation growth. Based on the state's current debt issuance projections and an assumed combined average annual General Fund revenue growth rate of between 2 percent to 5 percent, the state's General Fund Debt Ratio in fiscal year 2019-20 is projected to range from 7.26 percent to 8.67 percent. The General Fund Debt Ratio is calculated based on actual gross debt service, without adjusting for receipts from the U.S. Treasury for the state's current outstanding general obligation and lease-revenue BABs, and an assumed interest rate of 6.25 percent and 6.75 percent for future issuances of general obligation and lease-revenue bonds, respectively. See the table "OUTSTANDING STATE DEBT, FISCAL YEARS, 2004-05 THROUGH 2008-09" under "STATE

DEBT TABLES” for certain historical ratios of debt service to General Fund receipts. The actual General Fund Debt Ratio in future fiscal years will depend on a variety of factors, including actual debt issuance (which may include additional issuance approved in the future by the Legislature and, for general obligation bonds, the voters), actual interest rates, debt service structure, and actual General Fund revenues and transfers.

Economic Recovery Bonds

The California Economic Recovery Bond Act (“Proposition 57”) was approved by the voters on March 2, 2004. Proposition 57 authorized the issuance of up to \$15 billion in ERBs to finance the negative General Fund reserve balance as of June 30, 2004, and other General Fund obligations undertaken prior to June 30, 2004. Repayment of the ERBs is secured by a pledge of revenues from a one-quarter cent increase in the state’s sales and use tax that became effective July 1, 2004. In addition, as voter-approved general obligation bonds, the ERBs are secured by the state’s full faith and credit and payable from the General Fund in the event the dedicated sales and use tax revenue is insufficient to repay the bonds.

In May and June 2004, the state issued \$10.896 billion principal amount of ERBs, resulting in the deposit of net proceeds to the General Fund of approximately \$11.254 billion. In order to relieve cash flow and budgetary shortfalls identified in the 2008-09 Governor’s Budget, the state issued approximately \$3.179 billion of additional ERBs on February 14, 2008, generating net proceeds of \$3.313 billion which were transferred to the General Fund. No further ERBs can be issued under Proposition 57, except for refunding bonds which may be issued in the future. (The Department of Finance had determined that the full \$15 billion voter authorization could not be issued because of the previous repayment of certain June 30, 2004 obligations eligible for financing pursuant to Proposition 57.)

Because of the sharp reduction in taxable sales as a result of the recent economic recession, the Special Sales Tax Revenues (“SSTRs”) collected from the one-quarter cent tax dedicated to repayment of the ERB debt decreased to a level which did not provide adequate coverage above the required debt service amounts for the 2004 and 2008 ERBs. This resulted in downgrades of the ratings of the ERBs and would have required debt service to be paid from reserve funds for at least some period of time. In order to restore adequate coverage, the state restructured the ERB debt through the issuance of approximately \$3.435 billion ERB refunding bonds on November 5, 2009. The restructuring reduced annual debt service costs to come into alignment with reduced tax revenues, with a coverage target of at least 1.3 times. The ratings for all ERBs have been raised to levels above the state’s general obligation bond ratings.

Three different sources of funds are required to be applied to the early retirement (generally by purchase or redemption) of ERBs: (i) all proceeds from the dedicated quarter cent sales tax in excess of the amounts needed, on a semi-annual basis, to pay debt service and other required costs of the bonds, (ii) all proceeds from the sale of specified surplus state property, and (iii) fifty percent of each annual deposit, up to \$5 billion in the aggregate, of deposits in the BSA (see “THE BUDGET PROCESS – Constraints on the Budget Process – Balanced Budget Amendment (Proposition 58)”). As of January 2010, funds from these sources have been used for early retirement of approximately \$3.5 billion of bonds during fiscal years 2005-06 through 2009-10, including \$1.495 billion which was transferred from the BSA in fiscal year 2006-07 (\$472 million) and fiscal year 2007-08 (\$1.023 billion). The state reported that approximately \$122 million of surplus tax revenues will be used to retire ERBs on June 24, 2010.

The Governor suspended each of the fiscal years 2008-09, 2009-10 and 2010-11 BSA transfers due to the condition of the General Fund.

Tobacco Settlement Revenue Bonds

In 1998 the state signed a settlement agreement (the “Master Settlement Agreement” or “MSA”) with the four major cigarette manufacturers (the “participating manufacturers” or “PMs”). Under the MSA, the PMs agreed to make payments to the state in perpetuity, which payments, at the time were predicted to total approximately \$25 billion (subject to adjustments) over the first 25 years. Under a separate Memorandum of Understanding, half of the payments made by the cigarette manufacturers is paid to the state and half to local governments. The specific amount to be received by the state and local governments is subject to adjustment. Details in the MSA require reduction of the PMs’ payments for decreases in cigarette shipment volumes by the PMs, payments owed to certain “Previously Settled States” and certain other types of offsets. However, settlement payments are adjusted upward each year by at least 3 percent for inflation, compounded annually.

State law enacted in 2002 (the “Tobacco Securitization Law”) authorized the establishment of a special purpose trust to purchase the tobacco assets and to issue revenue bonds secured by the tobacco settlement revenues received beginning in the 2003-04 fiscal year. Legislation in 2003 amended the Tobacco Securitization Law to authorize a “back-up state guaranty” that requires the Governor to request an appropriation from the General Fund in the annual Budget Act to pay debt service and other related costs of the tobacco settlement revenue bonds secured by the second 2003 sale of tobacco settlement revenues when such tobacco settlement revenues are insufficient. The Legislature is not obligated to make any General Fund appropriation.

In 2003, two separate sales of these assets financed with revenue bonds (the “2003 Bonds”) produced about \$4.75 billion in proceeds which were transferred to the General Fund. In 2005 and 2007, the state refunded all of the original 2003 Bonds, generating additional proceeds of approximately \$1.783 billion, which were also transferred to the General Fund. The back-up state guaranty was applied to only the second 2003 sale of bonds and was continued when those bonds were refunded in 2005 (the “2005 Refunding Bonds”). The back-up state guaranty now applies to the \$3.14 billion of 2005 Refunding Bonds.

The MSA provides for a *potential* reduction to the PMs’ payments under specified conditions relating to the loss of market share to non-participating manufacturers (“NPMs”). This potential reduction is called an “NPM adjustment.” The state disputes the PMs’ right to an NPM adjustment for any year. The MSA also allows the PMs to withhold any portion of their annual payments that is disputed, until such time as the dispute is resolved. Since 2006, the annual amount of revenues received by the state has incurred some level of withholding based on the PMs’ assertion of their right to receive an NPM adjustment as is reflected in the table below. Nevertheless, the annual amount of tobacco settlement revenues received to date has been in excess of the required debt service payments.

Year of Scheduled Payment	Approximate NPM Adjustment withheld
2006	\$ 50.9 million
2007	\$ 44.0 million
2008	\$ 33.9 million*
2009	\$ 32.8 million
2010	\$ 35.3 million

*In February 2009, these funds were released and remitted to the state as part of the NPM arbitration negotiations.
Source: State of California, Department of Finance.

The State Attorney General is pursuing, in a multi-state arbitration proceeding, a determination compelling the PMs to pay the full amount scheduled, given that the state asserts that it has been diligently enforcing the statute governing the NPMs, as required in the MSA.

Tobacco settlement revenue bonds are neither general nor legal obligations of the state or any of its political subdivisions and neither the faith and credit nor the taxing power nor any other assets or revenues of the state or of any political subdivision is or shall be pledged to the payment of any such bonds; provided that, in connection with the issuance of the 2005 Refunding Bonds, the state covenanted to request the legislature for a General Fund appropriation in the event tobacco settlement revenues fall short. Tobacco settlement revenues have been sufficient to pay debt service with respect to the tobacco settlement revenue bonds, and therefore the state's covenant to request an appropriation has never been invoked.

Obligations in Connection with Proposition 1A of 2004

The Amended 2009 Budget Act provided for state borrowing, pursuant to Proposition 1A of 2004, of approximately \$1.998 billion of local property tax revenues. In accordance with Proposition 1A of 2004, the state is required to repay such revenues no later than June 2013. See "THE BUDGET PROCESS – Constraints on the Budget Process- Local Government Finance (Proposition 1A of 2004)."

Legislation implementing the borrowing in the Amended 2009 Budget Act provided authority to local governments to sell their right to receive the state repayment to a joint powers authority (JPA) and for the JPA to issue bonds backed by the state's repayment obligation. The repayment obligation includes interest and issuance costs for the JPA bonds. See "STATE FINANCES – Local Governments."

On November 19, 2009, the California Statewide Communities Development Authority, a JPA, issued \$1,895,000,000 of bonds which are secured by the state's obligation to make these payments to about 1,300 local governments, representing about 95 percent of the state's total borrowing from local governments. The 2010-11 Governor's Budget includes \$90.8 million General Fund for the interest payments that will be incurred in that fiscal year. In accordance with the authorizing legislation, these bonds will be repaid by June 15, 2013. In addition, for the obligations to entities not participating in the JPA bond program (which are \$103 million in principal amount), the Director of Finance has set an interest rate of two percent per annum. See "STATE DEBT TABLES" for a schedule of payments.

Cash Flow Borrowings

As part of its cash management program, the state has regularly issued short-term obligations to meet cash flow needs. See "CASH MANAGEMENT."

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The following table shows the amount of RANs issued in the past five fiscal years and to date in the current fiscal year.

TABLE 6
State of California Revenue Anticipation Notes Issued
Fiscal Years 2004-05 to 2009-10
(Dollars in Billions)

Fiscal Year	Type	Principal Amount	Date of Issue	Maturity Date
2004-05	Notes Series A – D	\$6.0	October 6, 2004	June 30, 2005
2005-06	Notes	3.0	November 10, 2005	June 30, 2006
2006-07	Notes	1.5	October 3, 2006	June 29, 2007
2007-08	Notes	7.0	November 1, 2007	June 30, 2008
2008-09	Notes Series A-1	1.2	October 23, 2008	May 20, 2009
	Notes Series A-2	3.8	October 23, 2008	June 22, 2009
	Notes Series B-1	0.5	March 23, 2009	June 23, 2009
2009-10	Interim Notes	1.5	August 27, 2009	October 5, 2009*
	Notes Series A-1	2.825	September 29, 2009	May 25, 2010
	Note Series A-2	5.975	September 29, 2009	June 23, 2010

*Repaid on September 29, 2009 with a portion of the 2009-10 Notes Series A.

Source: State of California, Office of the State Treasurer.

Indirect, Nonpublic or Contingent Obligations

Flood Litigation Judgment. In 2005, the state settled a lawsuit arising from liability for past flood damages through a stipulated judgment in the amount of \$428 million, which provided for the state to make annual payments of \$42.8 million, plus interest, for 10 years; the payments are subject to annual appropriation by the Legislature. The Legislature has included the required annual installment in each budget act since the settlement was approved. This matter is not treated as a “debt” of the state for any legal or constitutional purposes.

Unemployment Insurance Fund Borrowing. As described in “STATE FINANCES – Unemployment Insurance,” commencing in January 2011, the state will be required to pay interest payments on loans made by the federal government to the state Unemployment Insurance (UI) Fund.

Special Fund Borrowings. As has been described in connection with various budget acts and current budget proposals, the General Fund has or may incur legal obligations to repay various Special Funds, or to repay schools or other local governments, for borrowings which have been treated as providing revenue to the General Fund. These loans may, in some cases, be further extended by the Legislature. Such loans are not treated as “debt” for any legal or constitutional purposes.

Office of Statewide Health Planning and Development Guarantees. Pursuant to a law created in 1969, the Office of Statewide Health Planning and Development (“OSHDP”) insures loans and bond issues for construction and renovation projects for nonprofit and publicly-owned healthcare facilities. The Program (commonly called “Cal-Mortgage Loan Insurance”) is currently authorized in statute to insure up to \$3 billion for health facility projects.

State law established the Health Facility Construction Loan Insurance Fund (“Fund”) as a trust fund which is continuously appropriated and may only be used for Program purposes. The Fund is used as a depository of fees and insurance premiums and is the initial source of funds used to pay administrative costs of the Program and shortfalls resulting from defaults by insured borrowers. If the Fund were unable to make payment on an insured loan or bond, state law provides for the State Treasurer

to issue debentures to the holders of the defaulted loan or bond which are payable on a parity with state general obligation bonds. All claims on insured loans to date have been paid from the Fund.

For the Fiscal year ending June 30, 2009, OSHPD insured approximately 134 loans to nonprofit or publicly owned health facilities throughout California for approximately \$1.7 billion. As of that date, the cash balance of the Fund was approximately \$192.6 million. The Office reported to the Legislature that as of June 30, 2009, the Fund balance was \$95.0 million (unaudited). The Fund balance is determined by taking the cash balance, adding the value of assets (obligations due to the Office for defaulted projects) and subtracting the liabilities (obligations of the Office for defaulted projects). The Office engaged Oliver Wyman to perform the 2008 Actuarial study of the Fund, which concluded, among other things, that it appeared to be sufficient, assuming “normal and expected” conditions, to maintain a positive balance over 30 years. Even assuming abnormal and unexpected events, the study found that the Fund’s reserves would protect against General Fund losses for 14 years. More information on the Program can be obtained from OSHPD’s website.

STATE FINANCES

The General Fund

The moneys of the state are segregated into the General Fund and over 1,000 other funds, including special, bond and trust funds. The General Fund consists of revenues received by the State Treasury and not required by law to be credited to any other fund, as well as earnings from the investment of state moneys not allocable to another fund. The General Fund is the principal operating fund for the majority of governmental activities and is the depository of most of the major revenue sources of the state. For additional financial data relating to the General Fund, see the financial statements incorporated in or attached to this APPENDIX A. See “FINANCIAL STATEMENTS.” The General Fund may be expended as a consequence of appropriation measures enacted by the Legislature and approved by the Governor (including the annual Budget Act), as well as appropriations pursuant to various constitutional authorizations and initiative statutes.

Budget Reserves

Special Fund for Economic Uncertainties

The SFEU is funded with General Fund revenues and was established to protect the state from unforeseen revenue reductions and/or unanticipated expenditure increases. The State Controller may transfer amounts in the SFEU to the General Fund as necessary to meet cash needs of the General Fund and such transfers are characterized as “loans.” The State Controller is required to return moneys so transferred without payment of interest as soon as there are sufficient moneys in the General Fund. At the end of each fiscal year, the State Controller is required to transfer from the SFEU to the General Fund any amount necessary to eliminate any deficit in the General Fund.

The legislation creating the SFEU (Government Code Section 16418) also contains a continuous appropriation authorizing the State Controller to transfer the unencumbered balance in the General Fund to the SFEU, as of the end of each fiscal year. However, if, at the end of any fiscal year in which it has been determined that there are revenues in excess of the amount that may be appropriated, as defined in subdivision (a) of Section 2 of Article XIII B of the California Constitution, this transfer shall be reduced by the amount of the excess revenues. The estimates of the transfer shall be made jointly by the LAO and the Department of Finance. For a further description of Article XIII B, see “State Appropriations Limit.” In certain circumstances, moneys in the SFEU may be used in connection with disaster relief.

For budgeting and accounting purposes, any appropriation made from the SFEU, other than appropriations contained in Government Code Section 16418, is deemed an appropriation from the

General Fund. For year-end reporting purposes, the State Controller is required to add the balance in the SFEU to the balance in the General Fund so as to show the total moneys then available for General Fund purposes.

See Table 1 and footnote (i) in Table 3 for information concerning the recent balances in the SFEU and projections of the balances for the previous and current fiscal years. As in any year, the Budget Act and related trailer bills are not the only pieces of legislation which appropriate funds. Other factors, including re-estimates of revenues and expenditures, existing statutory requirements and additional legislation introduced and passed by the Legislature may impact the fiscal year-end balance in the SFEU.

Budget Stabilization Account

Proposition 58, approved in March 2004, created the BSA as a second budgetary reserve. Beginning with fiscal year 2006-07, a specified portion of estimated annual General Fund revenues (reaching a ceiling of 3 percent by fiscal year 2008-09) will be transferred by the State Controller into the BSA no later than September 30 of each fiscal year unless the transfer is suspended or reduced as described below. These transfers will continue until the balance in the BSA reaches \$8 billion or 5 percent of the estimated General Fund revenues for that fiscal year, whichever is greater. The annual transfer requirement will go back into effect whenever the balance falls below the \$8 billion or the 5 percent target. The annual transfers can be suspended or reduced for a fiscal year by an executive order issued by the Governor no later than June 1 of the preceding fiscal year. Proposition 58 also provides that one-half of the annual transfers shall be used to retire ERBs, until a total of \$5 billion has been used for that purpose. A total of \$1.495 billion of the \$5 billion amount has now been applied to the retirement of ERBs. (See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Economic Recovery Bonds.")

The 2007, 2008, and 2009 Budget Acts give the Director of Finance the authority to transfer moneys from the BSA back into the General Fund in an amount determined by the Director of Finance to be sufficient to ensure there is a prudent General Fund balance. Using this authority, the Director of Finance ordered the transfer of the entire balance of \$1.495 billion from the BSA to the General Fund to address a fiscal emergency proclaimed by the Governor on January 10, 2008. Once moneys are transferred out of the BSA, pursuant to the authority, they will not be replenished by a future fiscal year's annual transfer unless the Legislature, by statute, directs additional funds to be transferred from the General Fund into the BSA. Separate from the foregoing process for a budgetary transfer, the BSA may be used to make temporary loans to the General Fund, which must be repaid when the General Fund has available cash, as described under "- Inter-Fund Borrowings."

In light of the condition of the General Fund, the Governor issued an Executive Order on May 28, 2008, suspending the fiscal year 2008-09 transfer of \$3.018 billion from the General Fund to the BSA, as had been proposed in the fiscal year 2008-09 Governor's Budget. Due to a drastic decline in General Fund revenues, the Governor issued an Executive Order on May 29, 2009, suspending the fiscal year 2009-10 transfer estimated at approximately \$2.8 billion from the General Fund to the BSA. The 2010-11 May Revision retains the January 10 proposal to suspend the fiscal year 2010-11 transfer estimated at approximately \$2.7 billion from the General Fund to the BSA. There are currently no moneys in the BSA.

Inter-Fund Borrowings

Inter-fund borrowing is used to meet temporary imbalances of receipts and disbursements in the General Fund. In the event the General Fund is or will be exhausted, the State Controller is required to notify the Governor and the PMIB (comprised of the State Director of Finance, the State Treasurer and the State Controller). The Governor may then order the State Controller to direct the transfer of all or any part of the moneys not needed in Special Funds to the General Fund, as determined by the PMIB. All money so transferred must be returned to the special fund from which it was transferred as soon as there

is sufficient money in the General Fund to do so. Transfers cannot be made which will interfere with the objective for which such special fund was created, or from certain specific funds. In general, when moneys transferred to the General Fund in any fiscal year from any special fund pursuant to the inter-fund borrowing mechanism exceed 10 percent of the total additions to such special fund as shown in the statement of operations of the preceding fiscal year as set forth in the Budgetary/Legal Basis Annual Report of the State Controller, interest must be paid on such excess at a rate determined by the PMIB to be the current earning rate of the PMIA. This provision does not apply to temporary borrowings from the BSA or other accounts within the General Fund.

The amount of loans from the SFEU, the BSA and other internal sources to the General Fund, as of the end of any month is displayed in the most recent State Controller's Statement of General Fund Cash Receipts and Disbursements, on the first page under "Borrowable Resources – Outstanding Loans." See EXHIBIT 1 – "State Controller's Statement of General Fund Cash Receipts and Disbursements, July 1, 2009 – May 31, 2010 (Unaudited)."

Any determination of whether a proposed borrowing from one of the Special Funds is permissible must be made with regard to the facts and circumstances existing at the time of the proposed borrowing. The State Attorney General has identified certain criteria relevant to such a determination. For instance, amounts in the Special Funds eligible for inter-fund borrowings are legally available to be transferred to the General Fund if a reasonable estimate of expected General Fund revenues, based upon legislation already enacted, indicates that such transfers can be paid from the General Fund promptly if needed by the Special Funds or within a short period of time if not needed. In determining whether this requirement has been met, the Attorney General has stated that consideration may be given to the fact that General Fund revenues are projected to exceed expenditures entitled to a higher priority than payment of internal transfers, i.e., expenditures for the support of the public school system and public institutions of higher education.

At the November 1998 election, voters approved Proposition 2. This proposition requires the General Fund to repay loans made from certain transportation special accounts (such as the State Highway Account) at least once per fiscal year, or up to 30 days after adoption of the annual Budget Act. Since the General Fund may reborrow from the transportation accounts any time after the annual repayment is made, the proposition does not have any adverse impact on the state's cash flow.

In connection with the adoption of the 2008 Budget Act, statutory changes sponsored by the Administration were enacted to clarify 18 existing state funds as borrowable resources for General Fund cash flow purposes. These funds increased the total amount of borrowable resources by approximately \$3.5 billion as of September 2008. An additional \$500 million of additional borrowable resources were previously made available in August 2008 as a result of administrative actions taken by the State Controller.

The February 2009 Budget Act also included clarification of an additional 19 funds as borrowable resources for General Fund cash flow purposes. These funds provide approximately \$2 billion of additional borrowable cash to the General Fund.

In addition to temporary inter-fund cash flow borrowings described in this section, budgets enacted in the current and past fiscal years have included other budgetary transfers and long-term loans from Special Funds to the General Fund. In some cases, such budgetary loans and transfers have the effect of reducing internal borrowable resources.

The following table shows internal borrowable resources available for temporary cash flow loans to the General Fund on June 30 of each of the fiscal years 2006-07 through 2010-11 and estimates the amount currently available based on the 2010-11 May Revision. See also EXHIBIT 1 – "State Controller's Statement of General Fund Cash Receipts and Disbursements, July 1, 2009 – May 31, 2010

(Unaudited).” The amount of internal borrowable resources fluctuates throughout the year. For the fiscal year 2009-10, based on actual results through May 2010 and projections for June 2010, the lowest amount of unused internal borrowable resources was approximately \$2.3 billion in July 2009. (Unused internal borrowable resources would have been lower in such period if the state had not issued approximately \$1.5 billion in registered warrants in July 2009.)

TABLE 7
Internal Borrowable Resources
(Cash Basis)
(Dollars in Millions)

	<u>2007</u>	<u>2008</u>	<u>June 30, 2009</u>	<u>2010^(a)</u>	<u>2011^(a)</u>
Available Internal Borrowable Resources	\$14,888.6	\$14,209.4	\$19,037.7	\$17,944.7	\$18,195.0
Outstanding Loans					
From Special Fund for Economic Uncertainties and Budget Stabilization Account	--	1,451.8	1,539.6	478.7	1,205.0
From Special Funds and Accounts	--	--	10,368.5	11,221.1	4,129.8
Total Outstanding Internal Loans	--	(1,451.8)	(11,908.1)	(11,699.8)	(5,334.8)
Unused Internal Borrowable Resources	\$14,888.6	\$12,757.6	\$7,129.6	\$6,244.9	\$12,860.2

^(a) Estimates based on the 2010-11 May Revision.

Source: Years ended June 30, 2007 through June 30, 2009: State of California, Office of the State Controller.
Years ended June 30, 2010 and 2011: State of California, Department of Finance.

State Warrants

No money may be drawn from the State Treasury except upon a warrant duly issued by the State Controller. The State Controller is obligated to draw every warrant on the fund out of which it is payable for the payment of money directed by state law to be paid out of the State Treasury; however, a warrant may not be drawn unless authorized by law and unless unexhausted specific appropriations provided by law are available to meet it. As described below, state law provides two methods for the State Controller to respond if the General Fund has insufficient “Unapplied Money” available to pay a warrant when it is drawn, referred to generally as “registered warrants” and “reimbursement warrants.” “Unapplied Money” consists of money in the General Fund for which outstanding warrants have not already been drawn and which would remain in the General Fund if all outstanding warrants previously drawn and then due were paid subject to the prior application of such money to obligations of the state with a higher priority. See “STATE INDEBTEDNESS AND OTHER OBLIGATIONS - Cash Flow Borrowings.” Unapplied Money may include moneys transferred to the General Fund from the SFEU and the BSA and internal borrowings from state Special Funds (to the extent permitted by law), however the state is not obligated to utilize interfund borrowings for the payment of state obligations if insufficient “Unapplied Money” is available for such payment. See “STATE FINANCES - Budget Reserves - Special Fund for Economic Uncertainties” and “-Inter-Fund Borrowings.”

Registered Warrants

If a warrant is drawn on the General Fund for an amount in excess of the amount of Unapplied Money in the General Fund, after deducting from such Unapplied Money the amount, as estimated by the

State Controller, required by law to be earmarked, reserved or set apart for the payment of obligations having priority over obligations to which such warrant is applicable, the warrant must be registered on the reverse side as not paid because of the shortage of funds in the General Fund. The State Controller may issue registered warrants before exhausting all cash management techniques that could provide Unapplied Money to the General Fund. See “CASH MANAGEMENT.”

Registered warrants are interest bearing obligations that may be issued either with or without a maturity date. Most registered warrants bear interest at a rate designated by the PMIB up to a maximum of five percent per annum except, if the PMIB determines that it is in the best interests of the state to do so, the PMIB may fix the rate of interest paid on registered warrants at no more than 12 percent per annum. If issued with a maturity date, the principal and interest on such warrant will not be due until that date (although it may be optionally redeemed early if the state has sufficient Unapplied Money to do so) and the state may make other payments prior to that maturity date. If a registered warrant is issued without a maturity date, or its maturity date has occurred, it must be redeemed when the State Controller, with the approval of the PMIB, determines that the General Fund contains sufficient Unapplied Money to permit its payment. The duties of the State Controller and the PMIB are ministerial in nature, and the State Controller and the PMIB may not legally refuse to make such determinations and provide such approvals with respect to a registered warrant for which sufficient Unapplied Moneys are available in the General Fund after all priority payments have been made on that date.

State law generally requires that registered warrants be paid when due in the order they are issued. The state issued approximately \$2.6 billion of registered warrants to pay certain obligations of the state not having payment priority under law commencing on July 2, 2009, all of which were called for early redemption on September 4, 2009. (The State Controller was able to manage cash resources to ensure that higher priority payments, such as for schools and debt service, were made on time in July and August 2009.) As of May 20, 2010, approximately \$16 million of registered warrants have yet to be presented for redemption and currently remain outstanding. The issuance of the registered warrants permitted the state to pay Priority Payments with regular warrants which could be cashed.

Reimbursement Warrants

In lieu of issuing individual registered warrants to numerous creditors, state law provides an alternative procedure whereby the Governor, upon request of the State Controller, may authorize utilizing the General Cash Revolving Fund in the State Treasury to borrow from other state Special Funds to meet payments authorized by law. The State Controller may then issue “reimbursement warrants” (sometimes called “revenue anticipation warrants” or “RAWs”) for sale to investors to reimburse the General Cash Revolving Fund, thereby increasing cash resources for the General Fund to cover required payments. The General Cash Revolving Fund exists solely to facilitate the issuance of reimbursement warrants. Reimbursement warrants have a fixed maturity date which may not be later than the end of the fiscal year following the year in which they were issued.

The principal of and interest on reimbursement warrants must be paid by the State Treasurer on their respective maturity dates from any Unapplied Money in the General Fund and available for such payment. In the event that Unapplied Money is not available for payment on the respective maturity dates of reimbursement warrants, and refunding warrants (see “– Refunding Warrants”) have not been sold at such times as necessary to pay such reimbursement warrants, such reimbursement warrants will be paid, together with all interest due thereon (including interest accrued at the original interest rate after the maturity date), at such times as the State Controller, with the approval of the PMIB, may determine.

The state has issued reimbursement warrants on several occasions in order to meet its cash needs when state revenues were reduced because of an economic recession, and the state incurred budget deficits. The state most recently issued reimbursement warrants in June 2002 and in June 2003.

Refunding Warrants

If it appears to the State Controller that, on the maturity date of any reimbursement warrant there will not be sufficient Unapplied Money in the General Fund to pay maturing reimbursement warrants, the State Controller is authorized under state law, with the written approval of the State Treasurer, to issue and sell refunding warrants to refund the prior, maturing reimbursement warrants. Proceeds of such refunding warrants must be used exclusively to repay the maturing warrants. In all other respects, refunding warrants are treated like reimbursement warrants, as described above.

Sources of Tax Revenue

The following is a summary of the state's major tax revenues and tax laws. Further information on state revenues is contained under "CURRENT STATE BUDGET," and "STATE FINANCES – Recent Tax Receipts." In fiscal year 2008-09, approximately 90 percent of the state's General Fund revenues and transfers were derived from personal income taxes, corporation taxes, and sales and use taxes. See Table 9 titled "Comparative Yield of State Taxes-All Funds, 2005-06 Through 2010-11" for a summary of the actual and projected sources of the state's tax revenue for those fiscal years.

The sections below captioned "Sales and Use Tax" and "Corporation Tax" include descriptions of pending lawsuits relating to various taxes.

Personal Income Tax

The California personal income tax, which accounted for 52.4 percent of General Fund revenues and transfers in fiscal year 2008-09, is closely modeled after the federal income tax law. It is imposed on net taxable income (gross income less exclusions and deductions), with rates ranging from 1 percent to 9.3 percent. For tax years 2009 and 2010, the rates will range from 1.25 percent to 9.55 percent. The personal income tax is adjusted annually by the change in the consumer price index to prevent taxpayers from being pushed into higher tax brackets without a real increase in income. Personal, dependent, and other credits are allowed against the gross tax liability. In addition, taxpayers may be subject to an alternative minimum tax ("AMT"), which is much like the federal AMT. The personal income tax structure is considered to be highly progressive. For example, the Franchise Tax Board (FTB) indicates that the top 1 percent of taxpayers paid 43 percent of the total personal income tax in tax year 2008.

Proposition 63, approved by the voters in the November 2004 election, imposes a 1 percent surcharge on taxable income over \$1 million in addition to the 9.3 percent rate (9.55 percent for tax years 2009 and 2010). The surcharge became effective January 1, 2005. The proceeds of the tax surcharge are required to be used to expand mental health programs.

Taxes on capital gains realizations, which are largely linked to stock market performance, can add a significant dimension of volatility to personal income tax receipts. Capital gains tax receipts accounted for 14.8 percent of General Fund revenues and transfers in 2000-01. The 2010-11 May Revision projects that capital gains will account for 3.6 percent of General Fund revenues and transfers in fiscal year 2009-10 and 5.8 percent in fiscal year 2010-11.

Sales and Use Tax

The sales and use tax (referred to herein as the "sales tax"), which accounted for 28.7 percent of General Fund revenues and transfers in fiscal year 2008-09, is imposed upon retailers for the privilege of selling tangible personal property in California. Most retail sales and leases are subject to the tax. However, exemptions have been provided for certain essentials such as food for home consumption, prescription drugs, gas delivered through mains, and electricity. Other exemptions provide relief for a variety of sales ranging from custom computer software to aircraft.

The California use tax is imposed at the same rates as the regular sales tax on consumers of tangible personal property that is used, consumed, or stored in this state. Use tax applies to purchases from out-of-state vendors that are not required to collect tax on their sales. Use tax also applies to most leases of tangible personal property.

As of May 1, 2010, the breakdown of the base state and local sales tax rate of 8.25 percent was as follows:

- 6 percent imposed as a state General Fund tax (this tax rate is scheduled to return to 5 percent on July 1, 2011);
- 0.5 percent dedicated to local governments for health and welfare program realignment (Local Revenue Fund);
- 0.5 percent dedicated to local governments for public safety services (Local Public Safety Fund);
- 1 percent local tax imposed under the Uniform Local Sales and Use Tax Law, with 0.25 percent dedicated to county transportation purposes and 0.75 percent for city and county general-purpose use; and
- 0.25 percent deposited into the Fiscal Recovery Fund to repay the state's ERBs (the "special sales tax").

Existing law provides that 0.25 percent of the base state and local sales tax rate may be suspended in any calendar year upon certification by the Director of Finance, by November 1 in the prior year, that both of the following have occurred: (1) the General Fund reserve (excluding the revenues derived from the 0.25 percent special sales tax) is expected to exceed 3 percent of revenues in that fiscal year (excluding the revenues derived from the 0.25 percent special sales tax) and (2) actual revenues for the period May 1 through September 30 equal or exceed the previous May Revision forecast. The 0.25 percent rate will be reinstated the following year if the Director of Finance subsequently determines conditions (1) or (2) above are not met for that fiscal year. The Department of Finance estimates that the reserve level will be insufficient to trigger a reduction for calendar year 2010. See "AMENDED 2009 BUDGET ACT – Summary of State Revenues and Expenditures" for a projection of the fiscal year 2008-09 General Fund reserve.

Existing law provides that the special sales tax will be collected until the first day of the calendar quarter at least 90 days after the Director of Finance certifies that all ERBs and related obligations have been paid or retired or provision for their repayment has been made or enough sales taxes have been collected to pay all ERBs and related obligations to final maturity. At such time the special sales tax will terminate and the city and county portion of taxes under the uniform local sales and use tax will be automatically increased by 0.25 percent. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Economic Recovery Bonds."

Proposition 1A of 2004, approved by the voters in the November 2004 election, amended the state Constitution to, among other things, reduce the Legislature's authority over local government revenue sources by restricting the state from lowering the local sales tax rate or changing the allocation of local sales tax revenues without meeting certain conditions. See "STATE FINANCES – Local Governments." A proposed initiative constitutional amendment, which has not yet been certified for the November 2, 2010 election ballot, would restrict the ability of the state to use or borrow money from local governments, and moneys dedicated to transportation financing.. See "THE BUDGET PROCESS – Proposed November 2010 Initiatives."

An appellate court decision from 2008 held that two Dell entities and two providers of maintenance and warranty services had improperly collected from customers and remitted to the BOE use tax on optional service contracts that were sold with computers. The state anticipates that a pending action will result in a judgment or settlement requiring the BOE to refund the tax with interest. Plaintiffs estimate that the refund amounts could be as much as \$250 million. Identification and notification of consumers affected by the decision and thus due a refund is unresolved, and determination of the total refund amount depends upon such identification and notification. The 2010-11 May Revision projects that the refunds will not occur prior to fiscal year 2011-12. See “LITIGATION – Tax Cases.”

Corporation Tax

The corporation tax accounted for 11.5 percent of General Fund revenues and transfers in fiscal year 2008-09.

Corporation tax revenues are derived from the following taxes:

1. The franchise tax and the corporate income tax are levied at an 8.84 percent rate on profits. The former is imposed on corporations for the privilege of doing business in California, while the latter is imposed on corporations that derive income from California sources but are not sufficiently present to be classified as doing business in the state.
2. Banks and other financial corporations are subject to the franchise tax plus an additional tax at the rate of 2 percent on their net income. This additional tax is in lieu of personal property taxes and business license taxes.
3. The AMT is similar to that in federal law. In general, the AMT is based on a higher level of net income computed by adding back certain tax preferences. This tax is imposed at a rate of 6.65 percent.
4. A minimum franchise tax of up to \$800 is imposed on corporations subject to the franchise tax but not on those subject to the corporate income tax. New corporations are exempted from the minimum franchise tax for the first year of incorporation.
5. Sub-Chapter S corporations are taxed at 1.5 percent of profits.
6. Fees paid by limited liability companies (“LLCs”), which account for 2.8 percent of corporation tax revenue, are considered “corporation taxes.” Three separate cases have been filed challenging the constitutionality of the LLC fee. Two have been resolved and one is pending. See “LITIGATION - Tax Cases.”

In *California Taxpayers Association v. Franchise Tax Board*, California Taxpayers Association (“Cal-Tax”) challenged the constitutionality of the corporate understatement penalty that was enacted in Chapter 1, Statutes of 2007-08 First Extraordinary Session (SB X1 28, 2008 Budget Act Trailer Bill) and sought an injunction precluding the Franchise Tax Board from enforcing the statute. The trial court ruled for the state and Cal-Tax appealed. A decision may be issued during fiscal year 2010-11. An adverse ruling would result in a potential loss or revenue in fiscal year 2010-11 of between \$500 million and \$800 million, and an ongoing loss of about \$500 million thereafter. See “LITIGATION – Tax Cases.”

As part of the 2009 Budget Act, the Legislature adopted certain additional tax benefits for corporations, affecting carryover of losses, sharing tax credits among affiliates, and changes to the unitary tax calculations for multinational corporations, all of which were to become effective in 2011 or later. An initiative statute has been submitted for possible inclusion on the November 2010 ballot which would repeal all of these new tax benefits. It is estimated that such a repeal, if qualified for the ballot and

approved by the voters, would increase General Fund revenues by about \$1.7 billion annually starting in fiscal year 2011-12.

Insurance Tax

The majority of insurance written in California is subject to a 2.35 percent gross premium tax. For insurers, this premium tax takes the place of all other state and local taxes except those on real property and motor vehicles. Exceptions to the 2.35 percent rate are certain pension and profit-sharing plans which are taxed at the lesser rate of 0.5 percent, surplus lines and non-admitted insurance at 3 percent and ocean marine insurers at 5 percent of underwriting profits. To provide interim funding for the Healthy Families and Medi-Cal programs, Chapter 157, Statutes of 2009 extends the 2.35-percent gross premiums tax to the Medi-Cal managed care plans in 2009 and 2010.

The BOE ruled in December 2006 that the premium tax insurers pay should be calculated on a cash basis rather than the accrual method required by the Department of Insurance. This ruling is expected to result in a total loss of \$406 million spread over several years; the impact was \$15 million in fiscal year 2008-09 and is estimated to be \$11 million in fiscal year 2009-10, \$230 million in fiscal year 2010-11, and \$149 million in fiscal year 2011-12.

Vehicle License Fee

The Amended 2009 Budget Act temporarily increased the vehicle license fee from 0.65 percent to 1.15 percent, effective May 19, 2009, through June 30, 2011. Of this 0.5 percent increase, 0.35 percent goes to the General Fund with the remaining 0.15 percent going to local law enforcement.

An initiative has been qualified for the November 2010 ballot which would increase the annual vehicle license fee by \$18 and dedicate the revenue to support of state parks and wildlife conservation. This measure, if approved by the voters, would generate an estimated \$500 million per year for parks and wildlife conservation programs, which would save an equivalent amount of General Fund expenditures.

Estate Tax; Other Taxes

The state estate tax is based on the state death tax credit allowed against the federal estate tax. The California estate tax is designed to pick up the maximum credit allowed against the federal estate tax return. The federal Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Economic Growth and Tax Relief Reconciliation Act") phases out the federal estate tax by 2010. As a consequence, the Economic Growth and Tax Relief Reconciliation Act resulted in the reduction of the state estate tax revenues by 25 percent in calendar year 2002, 50 percent in calendar year 2003, and 75 percent in calendar year 2004, and the elimination of the state estate tax beginning in calendar year 2005. The provisions of this federal act sunset after 2010. At that time, the federal estate tax is scheduled to be reinstated along with the state's estate tax. Federal estate tax law may be changed to modify or eliminate the state pick-up tax. See Table 9 titled "Comparative Yield of State Taxes – All Funds."

Other General Fund major taxes and licenses include: Inheritance and Gift Taxes; Cigarette Taxes; Alcoholic Beverage Taxes; Horse Racing License Fees and Trailer Coach License Fees.

Special Fund Revenues

The California Constitution and statutes specify the uses of certain revenues. Such receipts are accounted for in various Special Funds. In general, special fund revenues comprise three categories of income:

- Receipts from tax levies which are allocated to specified functions, such as motor vehicle taxes and fees and certain taxes on tobacco products.
- Charges for special services to specific functions, including such items as business and professional license fees.
- Rental royalties and other receipts designated for particular purposes (e.g., oil and gas royalties).

Motor vehicle related taxes and fees are projected to account for 39 percent of all special fund revenues in fiscal year 2010-11. Principal sources of this income are motor vehicle fuel taxes, registration and weight fees and vehicle license fees. In fiscal year 2010-11, \$10.9 billion is projected to come from the ownership or operation of motor vehicles. About \$2.9 billion of this revenue is projected to be returned to local governments. The remainder will be available for various state programs related to transportation and services to vehicle owners. For a discussion of Proposition 1A, approved by the voters in November 2004, which replaced a portion of vehicle license fees with increased property tax revenues, see “STATE FINANCES – Local Governments.” Vehicle license fees were increased temporarily as part of the Initial 2009 Budget Act. See “AMENDED 2009 BUDGET ACT.”

Taxes on Tobacco Products

As a result of Proposition 99, approved by the voters in 1988, and Proposition 10, approved by the voters in 1998, the state imposes an excise tax on cigarettes of 87 cents per pack and the equivalent rates on other tobacco products. Tobacco product excise tax revenues are earmarked as follows:

1. Fifty cents of the per-pack tax on cigarettes and the equivalent rate levied on non-cigarette tobacco products are deposited in the California Children and Families First Trust Fund and are allocated primarily for early childhood development programs.
2. Twenty-five cents of the per-pack tax on cigarettes and the equivalent rates levied on non-cigarette tobacco products are allocated to the Cigarette and Tobacco Products Surtax Fund. These funds are appropriated for anti-tobacco education and research, indigent health services, and environmental and recreation programs.
3. Ten cents of the per-pack tax is allocated to the state’s General Fund.
4. The remaining two cents of the per-pack tax is deposited into the Breast Cancer Fund.

Recent Tax Receipts

The following table shows the trend of major General Fund and total taxes per capita and per \$100 of personal income for the past four fiscal years, the current year and the budget year.

TABLE 8
Recent Tax Receipts

Fiscal Year	State Taxes per Capita^(a)		Taxes per \$100 of Personal Income	
	General Fund	Total	General Fund	Total
2005–06	2,451.75	2,867.55	6.52	7.63
2006–07	2,501.35	2,934.28	6.23	7.31
2007–08	2,530.79	2,967.26	6.06	7.11
2008–09	2,084.46	2,494.59	4.95	5.92
2009–10 ^(b)	2,189.84	2,571.00	5.40	6.34
2010–11 ^(b)	2,265.68	2,701.14	5.46	6.51

^(a) Data reflects population figures based on the 2000 Census.

^(b) Estimated.

Source: State of California, Department of Finance.

The following table displays the actual and estimated revenues by major source for the past four years, the current year, and the budget year. This table shows taxes that provide revenue both to the General Fund and state Special Funds.

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TABLE 9
Comparative Yield of State Taxes – All Funds
2005–06 Through 2010–11
(Modified Accrual Basis)
(Dollars in Thousands)

Year Ending June 30	Sales and Use ^(b)	Personal Income ^(b)	Corporation	Tobacco	Inheritance, Estate and Gift ^(c)	Insurance	Alcoholic Beverage	Horse Racing	Motor Vehicle Fuel ^{(d)(j)}	Motor Vehicle Fees ^(e)
2006	34,954,632 ^(a)	51,224,276	10,316,466	1,088,214	3,786	2,202,328	318,276	38,018	3,393,381	5,082,899
2007	35,502,500 ^(a)	53,352,906	11,157,897	1,078,553	6,347	2,178,336	333,789	37,528	3,399,694	5,176,621
2008	34,782,591 ^(a)	55,750,128	11,849,096	1,037,279	6,303	2,172,935	327,260	34,950	3,351,268	5,218,206
2009	31,390,845 ^(a)	44,360,228	9,535,679	1,000,434	245	2,053,850	323,934	30,737	3,162,299	5,636,427 ^(m)
2010 ^(f)	31,265,727 ^{(g)(i)}	44,751,000 ^(k)	9,386,000	911,649	--	2,266,209 ^(l)	332,000	19,958	3,115,020	6,731,749 ⁽ⁿ⁾
2011 ^(f)	31,023,611 ^{(g)(i)(j)}	47,185,000 ^(k)	9,779,000	892,649	892,000	2,129,613 ^(l)	354,000	21,783	5,533,928	6,870,881 ⁽ⁿ⁾

- (a) These figures include the General Fund allocation and the 0.5 percent Local Public Safety Fund. The figures do not include the voter approved local revenue, local city and county operations revenue (Bradley-Burns) which also includes the 0.25 percent county transportation funds revenue.
- (b) Includes the revenue estimate for a 1-percent surcharge on taxpayers with taxable income over \$1 million, with the proceeds funding mental health programs pursuant to Proposition 63.
- (c) The state estate tax is based on the state death tax credit allowed against the federal estate tax. As a result, the federal Economic Growth and Tax Relief Reconciliation Act progressively reduced the state estate tax in calendar years 2002 through 2004 and eliminated it beginning in calendar year 2005. Under current federal law, the estate tax will be reinstated after 2010.
- (d) Motor vehicle fuel tax (gasoline), use fuel tax (diesel and other fuels), and jet fuel. The 2011 figure includes the effect of an increase in the excise tax from 18 cents to 35.3 cents on motor vehicle gasoline and a decrease from 18 cents to 13.6 cents on motor vehicle diesel fuel.
- (e) Registration and weight fees, motor vehicle license fees and other fees. See "STATE FINANCES – Local Governments."
- (f) Estimated.
- (g) These estimated figures do not include the 0.5 percent Local Public Safety Fund revenue. These estimated figures also do not include voter approved local revenue, local city and county operations revenue (Bradley-Burns), or the 0.25 percent county transportation funds revenue. Estimate for fiscal year 2009-10 includes \$1.12 billion and for fiscal year 2010-11 includes \$1.20 billion for the temporary one-quarter cent tax described in footnote (h).
- (h) These figures include the temporary one-quarter cent tax increase which started to be collected in July 2004, and which is deposited in the Fiscal Recovery Fund and used for repayment of the Economic Recovery Bonds. See "STATE FINANCES–Sources of Tax Revenue – Sales and Use Tax."
- (i) Includes the impact of a temporary increase in the General Fund sales and use tax rate from 5 percent to 6 percent, effective April 1, 2009 through June 30, 2011.
- (j) Includes the impact of the fuel tax swap that eliminated the General Fund portion of sales and use tax on motor vehicle gasoline fuel sales.
- (k) Includes the revenue estimates for a temporary 0.25-percent surcharge applied to each marginal tax rate and the reduced dependent exemption credit for the 2009 and 2010 tax years.
- (l) Includes insurance tax on Medi-Cal managed care plans in 2009 and 2010 to provide interim funding for the Healthy Families and Medi-Cal programs.
- (m) Effective May 19, 2009 registration fees on Motor Vehicle Licenses Fee increased to 1.15 percent from 0.65 percent (excluding heavy vehicles). This rate increase will expire June 30, 2011.
- (n) Includes the impact of a temporary increase in the vehicle license fee from 0.65 percent to 1.15 percent, effective May 19, 2009 through June 30, 2011.

Note: This table shows taxes that provide revenue both to the General Fund and state Special Funds. Also, some revenue sources are dedicated to local governments.

Source: Fiscal Years 2005-06 through 2008-09: State of California, Office of the State Controller; Fiscal Years 2009-10 through 2010-11, State of California Department of Finance.

American Recovery and Reinvestment Act

Congress enacted the ARRA, which provides approximately \$787 billion of economic stimulus actions in the form of direct payments from the federal government and tax relief to individuals and businesses nationwide. The stimulus bill provides about \$330 billion in aid to states, about \$170 billion for federal projects and non-state aid, and about \$287 billion of tax relief.

The California Recovery Task Force estimates ARRA will have an \$85.4 billion effect in California, including \$55.2 billion in state aid and an additional \$30.2 billion in tax relief. The Recovery Task Force believes that over the 18 month course of ARRA ending in December 2010, Californians can expect to see a \$19.5 billion investment in health and human services, \$11.8 billion investment in education, \$5.2 billion investment in labor and workforce development, and \$4.7 billion investment in transportation infrastructure.

The 2010-11 May Revision includes an estimated \$5.0 billion in fiscal year 2009-10 and \$5.6 billion in fiscal year 2010-11 federal funds to offset General Fund expenditures. The majority of these federal funds are ARRA funds.

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State Expenditures

The following table summarizes the major categories of state expenditures, including both General Fund and special fund programs for fiscal years 2004-05 through 2008-09.

TABLE 10
Governmental Cost Funds
(Budgetary Basis)
Schedule of Expenditures by Function and Character
Fiscal Years 2004-05 to 2008-09
(Dollars in Thousands)

Function	2004-05	2005-06	2006-07	2007-08	2008-09
Legislative, Judicial, Executive					
Legislative	\$ 408,427	\$ 314,263	\$ 326,163	\$ 338,482	\$330,594
Judicial	2,881,680	3,164,602	3,515,815	3,902,038	3,962,289
Executive	1,361,910	1,504,886	1,634,180	1,761,510	1,669,476
State and Consumer Services	1,025,817	1,174,171	1,280,450	1,272,910	1,248,522
Business, Transportation and Housing					
Business and Housing	196,209	199,665	227,794	245,062	228,408
Transportation ^(a)	6,819,308	8,103,385	9,647,351	10,058,388	7,331,284
Resources	2,247,498	2,595,652	3,176,459	3,657,430	3,225,625
Environmental Protection	788,805	975,995	1,093,916	1,124,326	1,032,212
Health and Human Services	30,223,891	32,243,938	35,333,446	37,232,168	35,041,981
Correctional Programs	6,769,319	7,661,983	9,012,954	9,978,422	9,566,474
Education					
Education-K through 12	32,118,886	36,163,319	38,453,336	39,229,865	34,354,841
Higher Education	9,985,180	11,114,993	10,801,631	11,303,864	9,486,317
Labor and Workforce Development	319,984	353,970	406,464	421,116	414,307
General Government					
General Administration	(207,319)	1,842,451	2,240,543	1,796,460	1,728,781
Debt Service ^(b)	3,390,651	4,017,468	4,812,893	4,988,637	5,693,895
Tax Relief	665,597	666,691	666,504	669,140	480,312
Shared Revenues	1,691,964	3,003,378	2,117,815	1,649,546	1,976,050
Other Statewide Expenditures ^(c)	823,848	889,971	1,532,718	1,454,338	1,168,937
Expenditure Adjustment for Encumbrances ^(d)	(1,038,274)	(520,272)	(1,177,635)	(1,244,356)	551,826
Credits for Overhead Services by General Fund	(329,797)	(371,965)	(470,455)	(549,309)	(507,543)
Statewide Indirect Cost Recoveries	(74,581)	(83,338)	(86,071)	(88,045)	(94,458)
Total	\$100,069,003	\$115,015,206	\$124,546,271	\$129,201,992	\$118,890,130
Character					
State Operations	\$28,798,080	\$34,037,821	\$36,867,742	\$41,027,869	\$38,101,282
Local Assistance	70,216,800	78,626,805	84,578,753	85,603,560	78,795,864
Capital Outlay	1,054,123	2,350,580	3,099,776	2,570,563	1,992,984
Total	\$100,069,003	\$115,015,206	\$124,546,271	\$129,201,992	\$118,890,130

- (a) For fiscal years 2006-07 and 2007-08, the Transportation Investment Fund (Fund 3008) and the Transportation Deferred Investment Fund (Fund 3093) contracted for additional street and road repairs with monies provided by the General Fund per Revenue and Taxation Code Sections 7104 and 7107.
- (b) The Constitution makes payment of Debt Service on General Obligation Bonds one of the state's two highest fiscal priorities. Bond interest and redemption increased by \$697 million in fiscal year 2008-09 per the Governor's Budget Summary.
- (c) Assembly Bill 1634, (Chapter 723 Statutes of 2005) appropriated General Fund monies to reimburse the counties for the state's share of costs for the November 2005 special statewide election. County budgets statewide contain funding authority to support only one statewide election per year.
- (d) For fiscal year 2008-09 Expenditure Adjustments for Encumbrances has an abnormal balance due to prior year reversal of over encumbered expenditures. Subsequent Budget adjustments per Executive Order S-09-08 issued July 31st did not allow for full expenditure of anticipated encumbered expenses. Health and Human Services, Corrections and Rehabilitation, and Higher Education had the most significant reductions.

Source: State of California, Office of the State Controller.

State Appropriations Limit

The state is subject to an annual appropriations limit imposed by Article XIII B of the State Constitution (the “Appropriations Limit”). The Appropriations Limit does not restrict appropriations to pay debt service on voter-authorized bonds.

Article XIII B prohibits the state from spending “appropriations subject to limitation” in excess of the Appropriations Limit. “Appropriations subject to limitation,” with respect to the state, are authorizations to spend “proceeds of taxes,” which consist of tax revenues, and certain other funds, including proceeds from regulatory licenses, user charges or other fees to the extent that such proceeds exceed “the cost reasonably borne by that entity in providing the regulation, product or service,” but “proceeds of taxes” exclude most state subventions to local governments, tax refunds and some benefit payments such as unemployment insurance. No limit is imposed on appropriations of funds which are not “proceeds of taxes,” such as reasonable user charges or fees and certain other non-tax funds.

There are various types of appropriations excluded from the Appropriations Limit. For example, debt service costs of bonds existing or authorized by January 1, 1979, or subsequently authorized by the voters, appropriations required to comply with mandates of courts or the federal government, appropriations for qualified capital outlay projects, appropriations for tax refunds, appropriations of revenues derived from any increase in gasoline taxes and motor vehicle weight fees above January 1, 1990 levels, and appropriation of certain special taxes imposed by initiative (e.g., cigarette and tobacco taxes) are all excluded. The Appropriations Limit may also be exceeded in cases of emergency.

The Appropriations Limit in each year is based on the Appropriations Limit for the prior year, adjusted annually for changes in state per capita personal income and changes in population, and adjusted, when applicable, for any transfer of financial responsibility of providing services to or from another unit of government or any transfer of the financial source for the provisions of services from tax proceeds to non-tax proceeds. The measurement of change in population is a blended average of statewide overall population growth, and change in attendance at local school and community college (“K-14”) districts. The Appropriations Limit is tested over consecutive two-year periods. Any excess of the aggregate “proceeds of taxes” received over such two-year period above the combined Appropriations Limits for those two years, is divided equally between transfers to K-14 districts and refunds to taxpayers.

The Legislature has enacted legislation to implement Article XIII B which defines certain terms used in Article XIII B and sets forth the methods for determining the Appropriations Limit. California Government Code Section 7912 requires an estimate of the Appropriations Limit to be included in the Governor’s Budget, and thereafter to be subject to the budget process and established in the Budget Act.

The following table shows the Appropriations Limit for fiscal years 2006-07 through 2010-11.

TABLE 11
State Appropriations Limit
(Dollars in Millions)

	Fiscal Years				
	2006-07	2007-08	2008-09	2009-10	2010-11
State Appropriations Limit	\$72,307	\$76,093	\$79,858	\$80,984	\$79,118
Appropriations Subject to Limit	(58,663)	(59,201)	(48,233)	(57,849) ^(a)	(58,424) ^(a)
Amount (Over)/Under Limit	\$13,641	\$16,892	\$31,625	\$23,135 ^(a)	\$20,694 ^(a)

^(a) Estimated/projected.

Source: State of California, Department of Finance.

Proposition 98 and K-14 Funding

On November 8, 1988, the voters of the state approved Proposition 98, a combined initiative constitutional amendment and statute called the “Classroom Instructional Improvement and Accountability Act.” Proposition 98 changed state funding of public education below the university level and the operation of the Appropriations Limit, primarily by guaranteeing K-14 education a minimum level of funding (the “Proposition 98 Guarantee”). Proposition 98 (as modified by Proposition 111, enacted on June 5, 1990) guarantees K-14 education the greater of: (a) in general, a fixed percentage of General Fund revenues (“Test 1”), (b) the amount appropriated to K-14 education in the prior year, adjusted for changes in state per capita personal income and enrollment (“Test 2”), or (c) a third test, which replaces Test 2 in any year that the percentage growth in per capita General Fund revenues from the prior year plus one half of one percent is less than the percentage growth in state per capita personal income (“Test 3”).

Legislation adopted prior to the end of the 1988-89 fiscal year implementing Proposition 98 determined the K-14 education’s funding guarantee under Test 1 to be 40.7 percent of General Fund tax revenues based on 1986-87 appropriations. This percentage has since been adjusted to approximately 39.8 percent of 1986-87 appropriations to account for subsequent changes in the allocation of local property taxes since these changes altered the share of General Fund revenues received by schools, and in the 2010-11 May Revision, to account for elimination of state funding within the guarantee for state subsidized child care programs. The Proposition 98 Guarantee has typically been calculated under Test 2. Under Test 3, however, schools receive the amount appropriated in the prior year adjusted for changes in enrollment and per capita General Fund revenues, plus 0.5 percent. If Test 3 is used in any year, the difference between Test 3 and Test 2 becomes a “credit” (called the “maintenance factor”) to schools and is paid to them in future years when per capita General Fund revenue growth exceeds per capita personal income growth.

The Proposition 98 Guarantee is funded from two sources: local property taxes and the General Fund. Any amount not funded by local property taxes is funded by the General Fund. Thus, local property tax collections represent an offset to General Fund costs in a Test 2 or Test 3 year.

Proposition 98 permits the Legislature, by a two-thirds vote of both Houses (on a bill separate from the Budget Act) and with the Governor’s concurrence, to suspend the K-14 education’s minimum funding guarantee for a one-year period. The amount of the suspension is added to the maintenance factor, the repayment of which occurs according to a specified State Constitutional formula, and eventually restores Proposition 98 funding to the level that would have been required in the absence of such a suspension. Therefore, suspending the minimum funding guarantee provides ongoing General Fund savings over multiple fiscal years until the maintenance factor is fully repaid.

Proposition 98 also contains provisions for the transfer of certain state tax revenues in excess of the Appropriations Limit to K-14 education in Test 1 years when additional moneys are available. No such transfers are anticipated during fiscal years 2009-10 and 2010-11. See “STATE FINANCES – State Appropriations Limit.”

The Amended 2009 Budget Act reduced fiscal year 2008-09 Proposition 98 appropriations by \$7.3 billion from the \$58.1 billion assumed in the 2008 Budget Act through a combination of payment deferrals (\$3.2 billion), fund re-designations (\$1.7 billion), and program reductions (\$2.4 billion). In comparison to the fiscal year 2008-09 revised Proposition 98 spending level, the Initial 2009 Budget Act included an additional \$4.6 billion to backfill prior-year one-time solutions and \$252 million to fund growth adjustments. The fiscal year 2009-10 Proposition 98 appropriation level reflected an additional \$702 million in program reductions.

In July 2009, the Legislature adopted and the Governor signed legislation to further reduce Proposition 98 funding levels for both the 2008-09 and 2009-10 fiscal years. The fiscal year 2008-09 Proposition 98 funding level was established in statute at \$49.1 billion. This reflects another \$1.6 billion reduction beyond the Initial 2009 Budget Act. Furthermore, the Amended 2009 Budget Act reduced fiscal year 2009-10 appropriations by \$5.6 billion through a combination of payment deferrals (\$1.8 billion), program reductions (\$2.8 billion), and a technical adjustment related to the failure of Proposition 1C (The Lottery Modernization Act) (\$1.1 billion).

In the 2010-11 Governor's Budget, the Administration proposed to amend the fiscal year 2008-09 Proposition 98 funding level established in statute to reflect actual appropriations for fiscal year 2008-09, reducing Proposition 98 funding from \$49.1 billion to \$49.0 billion. The proposed fiscal year 2008-09 Proposition 98 funding level was \$2.2 billion over the minimum required funding level. For fiscal year 2009-10, the Proposition 98 Guarantee level was decreased to \$49.9 billion from the \$50.4 billion level in the Amended 2009 Budget Act. A portion of this reduction was achieved without any action as the cost of continuously appropriated programs is projected to be lower than estimated at the time of the Amended 2009 Budget Act. The Governor also reduced Proposition 98 funding to this level by reducing appropriations to reflect anticipated actual savings.

In the 2010-11 May Revision, the Administration withdrew its proposal to amend the statute that established a fiscal year 2008-09 Proposition 98 funding level because updated actual appropriations align closely with the \$49.1 billion level originally set in statute. For fiscal year 2009-10, the Proposition 98 Guarantee is funded at \$49.9 billion, consistent with the 2009-10 Governor's Budget. However, the actual Guarantee decreased \$503 million, and the Administration does not decrease funding for fiscal year 2009-10, but proposes to count this overappropriation as a down payment on the \$11.2 billion obligation created in statute during negotiations for the Amended 2009 Budget Act.

The Proposition 98 Guarantee for fiscal year 2010-11 is projected to decrease to \$48.4 billion from the 2010-11 Governor's Budget estimate of \$50.0 billion and the General Fund share is projected to be \$35.0 billion of total Proposition 98 funding. This reflects the revised Test 1 factor of 39.8 percent described above, including accounting for the Governor's proposed elimination of state subsidized child care programs.

The Budget reflects General Fund Proposition 98 expenditures in fiscal years 2008-09 through 2010-11, as outlined in the table below.

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TABLE 12
Proposition 98 Funding
(Dollars in Millions)

	2008-09		2009-10		2010-11	Change From Revised 2009-10 to Proposed 2010-11	
	Enacted^(a)	Revised^(b)	Enacted^(c)	Revised^(b)	Proposed^(b)	Amount	Percent
K-12 Proposition 98							
State General Fund	\$37,641	\$30,181	\$35,936	\$32,115	\$31,016	(\$1,099)	(3.4%)
Local property tax revenue	14,024	12,969	13,379	12,105	11,529	(576)	(4.7)
Subtotals ^(d)	\$51,665	\$43,150	\$49,315	\$44,220	\$42,545	\$(1,675)	(3.7)%
Other Proposition 98							
State General Fund	\$4,302	\$3,918	\$4,588	\$3,722	\$3,991	\$269	7.2%
Local property tax revenue	2,119	2,029	2,064	1,962	1,907	(55)	(2.8)
Subtotals ^(d)	\$6,421	\$5,947	\$6,652	\$5,684	\$5,898	\$214	3.7%
Total Proposition 98							
State General Fund	\$41,943	\$34,098	\$40,524	\$35,836	\$35,007	(\$830)	(2.3) %
Local property tax revenue	16,143	14,997	15,442	14,066	13,435	(631)	(4.4)
Totals ^(d)	\$58,086	\$49,096	\$55,966	\$49,903	\$48,442	\$(1,461)	(2.9%)

(a) As of the 2008 Budget Act, September 23, 2008.

(b) As of the 2010-11 May Revision, May 14, 2010.

(c) As of the Initial 2009 Budget Act, February 20, 2009.

(d) Totals may not add due to rounding.

Source: State of California, Department of Finance.

Legislation adopted with the Amended 2009 Budget Act created an outstanding obligation for the fiscal year 2008-09 of \$11.2 billion. This obligation will be repaid commencing in fiscal year 2010-11, in years when per capita General Fund revenue growth exceeds per capita personal income growth. Specifically, the obligation repayment is calculated as half the difference between the percentage increase in per capita General Fund revenue growth and per capita personal income growth multiplied by the General Fund subject to the State Appropriations Limit. As referenced above, the Administration proposes to make a payment of \$503 million towards this obligation in fiscal year 2009-10, leaving a balance of \$10.7 billion. In light of the state's current fiscal condition, the Administration proposes to delay commencing repayment of the remaining \$10.7 billion obligation from fiscal year 2010-11 until fiscal year 2011-12. Repayment amounts cannot be determined until certain Proposition 98 factors (e.g., per capita personal income and per capita General Fund revenue growth factors) are available. In addition, the Administration proposes to count the \$2.2 billion over appropriation of the Proposition 98 Guarantee in fiscal year 2008-09 as payment of the \$1.3 billion maintenance factor outstanding at the end of fiscal year 2007-08.

Legislation related to the 2004 Budget Act suspended the Proposition 98 minimum guarantee. At the time the 2004 Budget Act was enacted, this suspension was estimated to be \$2.004 billion. This suspended amount was added to the existing maintenance factor, which was fully paid in fiscal year 2005-06. However, subsequent growth in General Fund revenue increased the estimated fiscal year 2004-05 Proposition 98 Guarantee calculation by an additional \$1.6 billion. This additional funding, along with approximately \$1.1 billion in fiscal year 2005-06, was the subject of a lawsuit brought by the California Teachers Association ("CTA"), which has been settled. The terms agreed upon consist of retiring this approximately \$2.7 billion obligation beginning in fiscal year 2007-08 with a \$300 million payment and

then in annual payments of \$450 million beginning in fiscal year 2008-09 until the full amount is paid. Due to the state's severe revenue decline, the Amended 2009 Budget Act suspended this payment for fiscal year 2009-10. The 2010-11 Governor's Budget proposed to restart the annual settlement payments by providing \$270 million for fiscal year 2009-10 and \$180 million for fiscal year 2010-11, a total of \$450 million. However, the 2010-11 May Revision instead proposes to provide \$30 million for fiscal year 2009-10 and \$420 million for fiscal year 2010-11 for a total of \$450 million.

The CTA lawsuit settlement was ratified by legislation enacted in September of 2006 (Chapter 751, Statutes of 2006). In addition, legislation was approved to refinance the Golden State Tobacco Securitization Corporation's Series 2003A Bonds, which became effective on January 1, 2007. Of the \$1.258 billion in additional funds raised from the refinancing, which was completed on March 14, 2007, the first \$900 million offset initial costs of the settlement.

Proposition 98 appropriations for fiscal years 1995-96, 1996-97, 2002-03, and 2003-04 are cumulatively estimated to be \$1.4 billion below the amounts required by the Proposition 98 minimum guarantee for those years due to changes in various Proposition 98 factors applicable to those years. Chapter 216, Statutes of 2004, annually appropriates \$150 million per year beginning in fiscal year 2006-07, to repay these prior year Proposition 98 obligations. However, Chapter 491, Statutes of 2005, appropriated \$16.8 million toward these settle-up obligations during the fiscal year 2005-06 fiscal year, and explicitly reduced the first Chapter 216 settle-up appropriation from \$150 million to \$133.2 million for fiscal year 2006-07. Chapter 79, Statutes of 2006, appropriated \$133.2 million for the remaining balance of the fiscal year 2006-07 allocation and \$150 million for the fiscal year 2007-08 allocation. However, legislation related to the 2008 Budget Act suspended the fiscal year 2008-09 allocation. As a result, the outstanding settle-up balance as of the 2008 Budget Act was \$1.1 billion. The Initial 2009 Budget Act used the \$1.1 billion in settle-up moneys to pay for school district revenue limit costs in the 2008-09 fiscal year. The Amended 2009 Budget Act has further clarified that Proposition 98 appropriations for the 2006-07 fiscal year are \$212 million below the amounts required by the Proposition 98 minimum guarantee. This amount should be appropriated by the Legislature beginning in the 2014-15 fiscal year.

Most Proposition 98 mandates are currently deferred, rather than suspended. However, a recent court ruling now requires the state to either fully fund the costs of all education mandates (and not defer payment for them), or suspend the operation of those mandates. See "LITIGATION – Local Government Mandate Claims and Actions." The annual cost of reimbursing schools for existing mandates would be in the hundreds of millions of dollars. The 2010-11 Governor's Budget suspends most mandate costs. However, the 2010-11 Governor's Budget proposes to fund the inter-district and intra-district transfers and California High School Exit Exam mandates. The 2010-11 May Revision continues these same mandates-related proposals.

Local Governments

The primary units of local government in California are the 58 counties, which range in population from approximately 1,100 in Alpine County to approximately 10.4 million in Los Angeles County.

Counties are responsible for the provision of many basic services, including indigent health care, welfare, jails, and public safety in unincorporated areas. There are also 480 incorporated cities in California and thousands of special districts formed for education, utilities, and other services. The fiscal condition of local governments was changed when Proposition 13, which added Article XIII A to the State Constitution, was approved by California voters in 1978. Proposition 13 reduced and limited the future growth of property taxes and limited the ability of local governments to impose "special taxes" (those devoted to a specific purpose) without two-thirds voter approval. Although Proposition 13 limited

property tax growth rates, it also has had a smoothing effect on property tax revenues, ensuring greater stability in annual revenues than existed before Proposition 13 passed.

Proposition 218, another constitutional amendment enacted by initiative in 1996, further limited the ability of local governments to raise taxes, fees, and other exactions. (The limitations include requiring a majority vote approval for general local tax increases, prohibiting fees for services in excess of the cost of providing such service, and providing that no fee may be charged for fire, police, or any other service widely available to the public.)

In the aftermath of Proposition 13, the state provided aid to local governments from the General Fund to make up some of the loss of property tax moneys, including assuming principal responsibility for funding K-12 schools and community colleges. During the recession of the early 1990s, the Legislature reduced the post-Proposition 13 aid to local government entities other than K-12 schools and community colleges by requiring cities and counties to transfer some of their property tax revenues to school districts. However, the Legislature also provided additional funding sources, such as sales taxes, and reduced certain mandates for local services funded by cities and counties. See “STATE FINANCES – Sources of Tax Revenue – Sales and Use Tax” for a discussion of the impact of the Economic Recovery Bond issuances on local sales taxes.

The 2004 Budget Act, related legislation and the enactment of Proposition 1A in 2004 (described below) dramatically changed the state-local fiscal relationship. These constitutional and statutory changes implemented an agreement negotiated between the Governor and local government officials (the “state–local agreement”) in connection with the 2004 Budget Act. One change relates to the reduction of the vehicle license fee (“VLF”) rate from 2 percent to 0.65 percent of the market value of the vehicle. In order to protect local governments, which had previously received all VLF revenues, the 1.35 percent reduction in VLF revenue to cities and counties from this rate change was backfilled (or offset) by an increase in the amount of property tax revenues they receive. This worked to the benefit of local governments because the backfill amount annually increases in proportion to the growth in property tax revenues, which has historically grown at a higher rate than VLF revenues, although property tax revenues have declined over the past two years. This arrangement continues without change in the 2010-11 Governor’s Budget.

Pursuant to statutory changes made in conjunction with the Initial 2009 Budget Act, the VLF rate increased from 0.65 percent to 1.15 percent effective May 19, 2009. Of this 0.50 percent increase, 0.35 percent flows to the General Fund, and 0.15 percent supports various law enforcement programs previously funded by the state General Fund. This increased VLF rate will be effective through the 2010-11 fiscal year.

As part of the state-local agreement, voters at the November 2004 election approved Proposition 1A (“Proposition 1A of 2004”). Proposition 1A of 2004 amended the State Constitution to, among other things, reduce the Legislature’s authority over local government revenue sources by placing restrictions on the state’s access to local governments’ property, sales, and VLF revenues as of November 3, 2004. A detailed description of the provisions of this constitutional amendment is set forth below under the caption “THE BUDGET PROCESS – Constraints on the Budget Process – Local Government Finance (Proposition 1A of 2004).”

The Amended 2009 Budget Act authorized the state to exercise its authority under Proposition 1A of 2004 to borrow an amount equal to about 8 percent of local property tax revenues, or \$1.9 billion, which must be repaid within three years. State law was also enacted to create a securitization mechanism for local governments to sell their right to receive the state’s payment obligations to a local government-operated joint powers agency (JPA). This JPA sold bonds in a principal amount of \$1.895 billion in November 2009 to pay the participating local governments their full property tax allocations when they

normally would receive such allocations. Pursuant to Proposition 1A of 2004, the state is required to repay the local government borrowing (which in turn will be used to repay the bonds of the JPA) no later than June 30, 2013. The 2010-11 Governor's Budget includes \$90.8 million for the interest payments that will be incurred in that fiscal year to be paid from the General Fund.

The Amended 2009 Budget Act also contains a shift of \$1.7 billion in redevelopment agency funds from current revenue and reserves in fiscal year 2009-10 and \$350 million in fiscal year 2010-11. These revenues are shifted to schools that serve the redevelopment areas. This frees an equal amount of base property tax that is shifted to the Supplemental Education Revenue Augmentation Funds in each county that are established by Proposition 1A of 2004 and used for the same purposes. The enabling legislation allows redevelopment agencies to borrow from parent agencies, and from any available reserves in their Low and Moderate Income Housing Funds.

The California Redevelopment Association ("CRA"), whose membership includes a large number of redevelopment agencies, has filed a lawsuit challenging the \$1.7 billion shift described above. The 2008 Budget Act included a shift of \$350 million of redevelopment agency moneys. The CRA had also challenged that shift, and a trial court held that the legislation providing for the shift was invalid, which prevented the state from shifting the funds for the 2008-09 fiscal year. The state withdrew its appeal of the decision and subsequently enacted legislation that addresses the concerns noted by the trial court. However, the subsequently enacted legislation is being challenged in the current CRA lawsuit. A group of counties has filed a separate lawsuit challenging the shift. See "LITIGATION – Budget-Related Litigation - Actions Challenging Required Contribution by Redevelopment Agencies." The Sacramento County Superior Court issued a ruling on May 4, 2010 upholding the state's ability to shift \$1.7 billion and \$350 million from redevelopment agencies in fiscal years 2009-10 and 2010-11, respectively. The CRA has appealed the ruling.

Trial Courts

Prior to legislation enacted in 1997, local governments provided the majority of funding for the state's trial court system. The legislation consolidated the trial court funding at the state level in order to streamline the operation of the courts, provide a dedicated revenue source, and relieve fiscal pressure on the counties. The state's trial court system will receive approximately \$2.6 billion in state resources in fiscal year 2009-10 and \$2.7 billion in fiscal year 2010-11, as well as \$499 million in resources from the counties in each fiscal year. The 2010-11 May Revision reflects \$236.5 million in General Fund reductions for the trial court system, \$17.4 million of which is a one-time reduction. Of the remaining reduction amount, \$206.1 million is to be offset by special fund revenues. In addition, legislation enacted in 2008 provides California's court system with increased fees and fines to expand and repair its infrastructure to address significant caseload increases and reduce delays. The fees raised by this legislation are intended to support up to \$5 billion in lease-revenue bonds. Additional legislative authorization is required prior to the issuance of such lease-revenue bonds.

Welfare System

The entire statewide welfare system was changed in response to the change in federal welfare law enacted in 1996 (see "Welfare System"). Under the CalWORKs program, counties are given flexibility to develop their own plans, consistent with state law, to implement the program and to administer many of its elements. Counties are still required to provide "general assistance" aid to certain persons who cannot obtain welfare from other programs.

Welfare System

The Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193, the "Law") fundamentally reformed the nation's welfare system. The Law included provisions to: (i)

convert Aid to Families with Dependent Children (“AFDC”), an entitlement program, to Temporary Assistance for Needy Families (“TANF”), a block grant program with lifetime time limits on TANF recipients, work requirements and other changes; (ii) deny certain federal welfare and public benefits to legal noncitizens (subsequent federal law has amended this provision), allow states to elect to deny additional benefits (including TANF) to legal noncitizens, and generally deny almost all benefits to illegal immigrants; and (iii) make changes in the Food Stamp program, including reducing maximum benefits and imposing work requirements. The TANF block grant formula under the Law is operative through September 30, 2010, as further described below.

Chapter 270, Statutes of 1997, embodies California’s response to the federal welfare systems. Effective January 1, 1998, CalWORKs replaced the former AFDC program and California’s previous welfare program, Greater Avenues to Independence programs. Consistent with the federal law, CalWORKs contains time limits on the receipt of welfare aid, both lifetime as well as current period. The centerpiece of CalWORKs is the linkage of eligibility to work participation requirements.

Caseload under CalWORKs is projected to increase in fiscal year 2010-11. CalWORKs caseload projections are 552,000 cases in fiscal year 2009-10 and 569,000 cases in fiscal year 2010-11. Even with the increase in caseload, this still represents a major decline in caseload from the early 1990s, when caseload peaked at 921,000 cases in fiscal year 1994-95. Since CalWORKs’ inception in January 1998 through fiscal year 2010-11, caseload is projected to decline by over 10 percent.

The federal Deficit Reduction Act of 2005 (“DRA”) included legislation that reauthorized and extended the TANF program until September 30, 2010. The reauthorization legislation modifies countable work activities under TANF and applies new federal work participation rates to separate state programs. In addition, because reauthorization legislation effectively eliminates the state’s caseload reduction credit, the bulk of the CalWORKs caseload is subject to 50 percent work participation level requirement beginning in federal fiscal year (“FFY”) 2007.

Current policies are not expected to increase work participation rates enough to meet the federal requirement for at least 50 percent work participation among all families. In August 2009, the state received official notice from the federal government that California failed to meet the work participation rate for FFY 2007, the first year for which the DRA’s changes were effective. However, California’s penalty of approximately \$230 million was waived primarily due to the impact of program changes made in the DRA and California’s ability to engage nearly 30,000 families in work activities between FFY 2006 and FFY 2007. As a result of not meeting the work participation rate requirements, California’s required Maintenance of Effort (“MOE”) has increased to 80 percent of FFY 1994 historic expenditures rather than the 75 percent MOE level California is required to meet when work participation rates are achieved. The 2010-11 Governor’s Budget continues to reflect an increase of MOE spending by \$179.5 million in fiscal years 2009-10 and 2010-11, to \$2.9 billion, to reflect this penalty. The federal government recently notified California that it has not met the FFY 2008 work participation rate requirements and assessed a penalty of \$47.7 million. Under current state law, 50 percent of the penalty amount is the state’s responsibility and the remaining 50 percent would be shared among those counties not meeting work participation rate requirements. The state intends to seek relief from the FFY 2008 penalty based on current economic conditions and/or a corrective action plan. To the extent full or partial relief is not obtained, any FFY 2008 penalty likely would not be assessed prior to fiscal year 2011-12.

Considerable improvement in work participation rates must be achieved to avoid additional federal penalties, which could cost the state and counties more than \$2 billion over a five-year period, beginning in fiscal year 2011-12. Efforts to address improving work participation began during fiscal year 2006-07, and the state is continuing to identify and evaluate additional options that place greater emphasis on work participation and reduce reliance upon public assistance to significantly improve the

ability of the state and counties to meet federal work requirements in the TANF program. In addition, beginning in fiscal year 2011-12, the following long-term reforms will become effective:

- Restructuring time limits by requiring the adults in families that have received aid for a cumulative 48 months within a 60-month period to “sit out” and not receive aid for 12 months.
- Requiring all non-exempt recipients who are not meeting work requirements to meet face-to-face twice a year for a review with county employees.
- Strengthening the sanction process for adults who do not comply with program requirements by removing the adult portion of the grant if the adult refuses to comply within a cumulative total of three months.
- Reducing by 25 percent the child-only grant for non-work-eligible adults unless they meet work participation requirements. Counties may, at their own expense, provide services to enable these adults to meet program participation requirements. If they are successful in meeting program requirements, the child-only grant will continue to be provided at its full value.
- Eliminating the statutory COLA for CalWORKs. This statutory COLA was placed in law in the early 1970s. The COLA has been suspended during many of the years in which the state faced large budget deficits, including the current fiscal year.

Nationwide, the ARRA appropriated a combined total of \$5 billion for a new TANF Emergency Contingency Fund (“ECF”) for FFYs 2009 and 2010. A state can receive an ECF allocation for (i) caseload increases, (ii) increased expenditures for non-recurrent short term benefits, and/or (iii) increased expenditures for subsidized employment. Through the ECF, a state can be reimbursed for 80 percent of expenditures in FFY 2009 and FFY 2010 that exceed the level of state expenditures in each of these areas in FFY 2007 or FFY 2008, whichever is lower (California uses FFY 2007). The 2010-11 May Revision continues to assume an extension of the enhanced funding provided for health and social services programs by the ARRA. Absent the proposal to eliminate the CalWORKs program (see below), this would result in a General Fund decrease of \$386.6 million as a result of the federal government continuing the TANF-ECF provided to California through fiscal year 2010-11.

The 2010-11 May Revision continues to propose (i) reducing monthly grant payments by 15.7 percent to reduce California’s grant level to the average of the ten states with the highest cost of living, (2) reducing the level at which the state reimburses child care providers, and (3) eliminating the Recent Noncitizen Entrants program, which provides CalWORKs benefits to legal immigrants who have been in the United States for less than five years. These proposals were initially assumed to become effective June 1, 2010, for General Fund savings of \$207.2 million. However, due to delayed implementation to October 1, 2010 and a decreased caseload projection, the 2010-11 May Revision reduces the General Fund savings resulting from these proposals to \$138.8 million in fiscal year 2010-11. These savings would increase to approximately \$488 million if the federal government does not extend the TANF-ECF-ARRA funding described above.

Due to the severity of California’s structural deficit, the 2010-11 May Revision also proposes to eliminate the CalWORKs program, effective October 1, 2010, for net General Fund savings of \$1.07 billion in fiscal year 2010-11. These savings are in addition to the savings resulting from the proposals identified above. The savings amount consists of \$1.51 billion General Fund savings in direct CalWORKs expenditures, partially offset by a \$445.5 million General Fund increase to backfill the loss of TANF Block Grant funds in various programs, including Foster Care, Child Welfare Services, CalGrants, and the Department of Developmental Services. In addition, elimination of CalWORKs would result in forgoing \$386.6 million TANF ECF in fiscal year 2010-11.

Health Programs

Medi-Cal – Medi-Cal, California’s Medicaid program, is a health care entitlement program for low-income individuals and families who receive public assistance or otherwise lack health care coverage. Medi-Cal serves over one in six Californians. Federal law requires Medi-Cal to provide basic services such as doctor visits, laboratory tests, x-rays, hospital inpatient and outpatient care, hospice, skilled nursing care, and early periodic screening, diagnosis and treatment. Also, federal matching funds are available if states choose to provide any of numerous optional benefits. The federal government pays for half of the cost of providing most Medi-Cal services in California, including optional benefits. A wide range of public and private providers and facilities delivers these services. Providers are reimbursed by the traditional fee-for-service method or by capitated payments from managed care plans. Approximately 4.0 million Medi-Cal beneficiaries (more than half of the people receiving Medi-Cal benefits and services) are currently enrolled in managed care plans.

For the 2010-11 May Revision, Medi-Cal expenditures are estimated to be \$ 41.2 billion (\$10.1 billion General Fund) in fiscal year 2009-10 and \$48.8 billion (\$11.2 billion General Fund) in fiscal year 2010-11. There is a net increase of \$1.1 billion in Medi-Cal General Fund expenditures in fiscal year 2010-11, when compared to revised fiscal year 2009-10. This is the net result of:

(a) an increase in the base cost of about \$4.2 billion due to the currently scheduled end of ARRA enhanced funding (\$1.7 billion), removal of the Proposition 1A transfer (\$1.6 billion), base caseload and cost increases (\$0.9 billion), and other baseline issues.

(b) proposed savings of \$3.1 billion resulting from an anticipated increase in federal funds, various program reductions, and other solutions. Many of the solutions involve reductions in services and coverage, and will require approval of the Legislature.

The 2010-11 May Revision included \$720 million of General Fund savings from funds (to cover children’s health care costs in Medi-Cal) made available through the enacted AB 1383 hospital fee. Federal approval of the fee is necessary prior to implementation. The federal government is generally favorable of fees in some programs to provide the state match for obtaining the federal share of Medicaid services, provided that certain conditions are met. In this particular instance (AB 1383), the federal Centers for Medicare and Medicaid Services (“CMS”) has expressed concerns with California’s currently proposed fee structure. The Department of Health Care Services (“DHCS”) is working with the federal government to address their concerns so that the state policy can be implemented, yet cleanup state legislation will likely be necessary. Overall, the program uses fees on the industry to match federal funds, most of which are returned to Medi-Cal providers through supplemental payments, and \$720 million (\$80 million per quarter, through the end of the federal stimulus, which the President proposed for extension by six months from January 1 through July 1 in 2011) is designated for providing children’s health care in Medi-Cal.

Litigation is pending with respect to certain cost reductions implemented by the state. See “LITIGATION – Actions regarding Medi-Cal Reimbursements and Fees.”

Average monthly caseload in Medi-Cal is estimated at 7.28 million in fiscal year 2009-10. Caseload is expected to increase in fiscal year 2010-11 by approximately 262,300, or 3.6 percent, to 7.54 million eligible people.

The Family Planning, Access, Care and Treatment (“Family PACT”) Waiver program provides family planning services for low-income Californians. The state accesses over \$400 million a year in federal funds for the program. Under this waiver, California receives 90 cents on the dollar. As a result of continuing negotiations with the federal CMS, for the past five years (the waiver was to expire on November 30, 2004), the waiver has been operating on a month-to-month waiver extension basis. On

September 3, 2008, CMS sent the state final terms and conditions requiring California to make certain changes, including the implementation of more restrictive eligibility requirements, or the state will no longer be eligible for the matching federal dollars. On January 14, 2009, CMS sent another letter extending the current waiver until March 31, 2009 to allow additional time for negotiation between the state and CMS. On March 31, 2009 CMS granted a six-month waiver extension from April 1 until September 30, 2009. CMS has granted an additional extension through June 2010. Absent any change in law, the program will automatically be funded with General Fund dollars if the federal dollars are no longer available for California.

The 2008 Budget Act required the DHCS to achieve estimated savings of \$323.3 million through unallocated reductions as a result of historical expenditure trends in the program. The savings did not materialize for fiscal year 2008-09. In November 2007, the department noted similar concerns while initially reporting achieved savings of \$195.2 million of \$331 million expected for fiscal year 2007-08. At year end, the DHCS did achieve the full \$331 million General Fund savings plus an additional \$265 million General Fund savings. The Amended 2009 Budget Act assumes that DHCS achieves \$323.3 million in savings in fiscal year 2009-10. In the 2010-11 May Revision, the DHCS estimates savings of \$364.2 million in fiscal year 2009-10.

On February 17, 2009, President Obama signed ARRA, which enhances California's FMAP for the Medi-Cal program through December 31, 2010. The measure provides an across-the-board increase in FMAP to all states. Furthermore, states with significant changes in unemployment are eligible for an additional FMAP increase determined through a formula. California qualified for additional FMAP increase due to its high unemployment rate. California's current FMAP is 61.59 percent.

In February 2010, the federal government announced it would apply the federal ARRA FMAP to the clawback for October 2008 through December 31, 2010. The "clawback" is a payment made to the federal government to compensate for state Medicaid savings that would otherwise result from the Medicare Part D prescription drug benefit. This action resulted in \$682.2 million one-time federal funds to offset the state's General Fund. DHCS used \$447.3 million in fiscal year 2009-10 to credit against the monthly Part D clawback payments, beginning with the January 2010 invoice that was paid in March 2010. The remaining amount would be used in fiscal year 2010-11.

SSI/SSP – The federal Supplemental Security Income ("SSI") program provides a monthly cash benefit to eligible seniors and persons with disabilities who meet the program's income and resource requirements. In California, the SSI payment is augmented with a State Supplementary Payment ("SSP") grant. The 2010-11 May Revision proposes \$2.7 billion in General Fund expenditures for fiscal year 2010-11, 6.9 percent less than the revised fiscal year 2009-10 funding level of \$3.0 billion. The average monthly caseload in this program is estimated to be 1.3 million recipients in fiscal year 2010-11, a 0.9 percent increase over the revised fiscal year 2009-10 projected level.

The 2010-11 May Revision proposes reductions of \$206.5 million in fiscal year 2010-11 by (i) reducing maximum SSP grants for individuals by \$15 per month to the federal minimum (SSP grants for couples are already at the federal minimum) and (ii) eliminating the Cash Assistance Program for Immigrants, which provides state-only benefits to legal immigrants who are not eligible for federal benefits. These proposals would become effective October 1, 2010.

The 2010-11 May Revision includes \$1.6 billion new federal funds to offset the General Fund due to additional federal flexibility or support in a number of targeted areas, including federal reimbursement for the cost of incarcerating undocumented immigrant felons, moneys owed the state for incorrect Medicare disability determinations, and recalculation of state Medicare Part D clawback payments after taking into consideration aggressive state rebates (which would reduce clawback costs to

California if these benefits were still provided through Medi-Cal), and possible General Fund relief through the new comprehensive Section 1115 Hospital Financing Waiver.

Department of Corrections and Rehabilitation

General - CDCR was established in July 2005 by combining the former Department of Corrections, Youth Authority, Board of Prison Terms, Narcotic Addict Evaluation Authority, Board of Corrections, Commission on Correctional Peace Officer Standards and Training, and Prison Industry Authority. CDCR is responsible for incarcerating the state's most serious adult and juvenile offenders and for supervising offenders released on parole to the community. Today, CDCR, as one of the largest departments in state government, operates 39 youth and adult correctional facilities, 46 camps, 3 Family Foundation facilities and 3 adult prisoner/mother facilities. In addition, the CDCR contracts for 15 adult parolee service centers and 12 adult community correctional facilities, and leases beds at 2 county jails. The CDCR also operates 227 youth and adult parole units and sub-units, 4 regional headquarters, 1 correctional training center, 3 licensed general acute care hospitals, 1 licensed skilled nursing facility, 1 hospice program for the terminally ill, 18 licensed correctional treatment centers, 5 hemodialysis clinics, and 19 outpatient housing units. In addition, the CDCR has 6 regional accounting offices and leases almost two million square feet of office space. The CDCR's infrastructure includes more than 42 million square feet of building space on more than 27,000 acres of land (42 square miles) statewide.

CDCR Budget – The 2010-11 May Revision includes total operating expenditures of \$9.0 billion for CDCR from all funding sources. Of this amount, \$8.7 billion comes from the General Fund. This total includes funds for debt service payments, personal services costs, and operating expenses and equipment. The CDCR budget includes funding for over 63,000 personnel years (one personnel year is the full-time equivalent of one employee) at a total cost for salaries and benefits of approximately \$6.3 billion. Lease payments and bond insurance costs total \$268.7 million, and the remaining funds are budgeted for operating expenses and equipment.

The 2010-11 May Revision includes reductions for CDCR totaling \$1.1 billion. Of these savings, approximately \$244 million would require further legislative approval to implement, and would require non-sex offender, non-serious, non-violent offenders convicted with a sentence of three years or less to serve their felony sentence in local jails. The reductions also include \$10.6 million related to a reduction in juvenile institution and parole populations and an \$811 million reduction to CDCR's medical budget to reduce the Receiver's Medical Services Program (as discussed below) per-inmate medical costs to a level comparable to other correctional health care programs. Currently, CDCR's per inmate medical cost is approximately twice that of states with comparably sized inmate populations.

CDCR Population - Under existing law, the average daily adult inmate population is projected to decrease by 4,780 inmates from 168,461 in fiscal year 2009-10 to 163,681 in fiscal year 2010-11. Under existing law the average daily parole population is projected to increase by 858 parolees from 118,342 in fiscal year 2009-10 to 119,200 in fiscal year 2010-11.

The Division of Juvenile Justice ("DJJ") average daily institution population is projected to decrease by 118 wards from 1,517 in fiscal year 2009-10 to 1,399 in fiscal year 2010-11. The juvenile parole average daily population is expected to decrease by 202 parolees from 1,722 in fiscal year 2009-10 to 1,520 in fiscal year 2010-11. The population decrease is primarily due to efforts made by DJJ to reduce the number of time adds given for behavioral violations and increase the number of time cuts given for positive behavior and program completions, which are both used to determine a ward's parole consideration date.

Litigation Concerning Prison Medical Care Services - In April 2001, a class-action lawsuit, now known as *Plata v. Schwarzenegger*, was filed in federal court contending that the state was in violation of the Eighth and Fourteenth Amendments to the U.S. Constitution by providing inadequate medical care to

prison inmates. Three other cases are pending in federal court challenging the adequacy of services to prisoners for mental health care, dental health care, and disability rights. The four cases are coordinated among the courts, but the lead action has been delegated to the *Plata* court. On June 30, 2005, the *Plata* court ordered the establishment of a receivership to take control of the CDCR's medical care system due to the state's delay in successfully implementing the changes required by the Stipulated Agreement for Injunctive Relief, entered into as the settlement of the *Plata v. Schwarzenegger* case. A medical care receiver ("Receiver") was appointed by the *Plata* court in February 2006, and given broad authority over CDCR's medical care program. The *Plata* court approved the Turnaround Plan of Action on June 16, 2008, but the Legislature did not approve funding for the plan.

Since the Receiver was appointed, he proposed and subsequently revised plans for, among other things, design and construction of health-related facilities and housing for inmates with medical or mental health care needs, and supporting infrastructure and ancillary facilities, at existing state correctional facilities statewide or at other appropriate state owned real property, as well as improvements to health care facilities at existing prison facilities statewide. The CDCR currently plans to meet the Receiver's needs through its implementation of the AB 900 Prison Construction Program. See "Prison Construction Program" below.

On October 27, 2008, the district court ordered the state to transfer \$250 million to the Receiver. The court indicated it would proceed later with additional amounts requested by the Receiver. The state appealed that order and the Ninth Circuit Court of Appeals dismissed the state's appeal for lack of jurisdiction, stating that the order to pay \$250 million was an interim order.

The state's motion asking the *Plata* court to terminate the Receiver was denied. The state appealed this denial and a hearing on the appeal was heard in the Ninth Circuit Court of Appeals in September 2009. Pending the outcome of these court proceedings, the Receiver continues to develop his construction plan.

See "LITIGATION – Prison Healthcare Reform and Reduction of Prison Population."

The 2010-11 May Revision includes \$943 million for the Receiver's Medical Services Program, which is a decrease of \$24 million compared to the 2010-11 Governor's Budget. The 2010-11 May Revision also includes \$517 million for the 2009-10 fiscal year for unanticipated operational expenses and for the implementation of the Turnaround Plan of Action.

As the court-appointed Receiver continues to address the delivery of medical services to inmates, additional cost pressures could be placed on the state's General Fund resources.

Ruling Concerning Prison Overcrowding – On August 4, 2009, a panel of three federal judges issued a ruling related to the class action lawsuits over medical care (*Plata*) and mental health care (*Coleman v. Schwarzenegger*). The ruling found that overcrowding is the primary cause of unconstitutional medical and mental health conditions in California's state prisons. The ruling required the state, within 45 days, to submit a plan to reduce the state prison population to 137.5 percent of the system's design capacity within two years, a reduction of approximately 46,000 inmates. The state filed a prisoner-release plan with the three-judge panel. On January 12, 2010, the three-judge panel issued its final order, containing the same rulings. The state has appealed the order to the U.S. Supreme Court. On June 14, 2010, the U.S. Supreme Court granted the state's request for review of the prisoner release order. The matter will be considered in the Court's 2010-11 term.

The ruling will not result in the immediate release of any prisoners, only the preparation of a population reduction plan. The fiscal and policy impact of the three-judge panel ruling is therefore unknown at this point, being dependent on the outcome of proposed budget solutions, the pace of

currently authorized prison construction, the timing of any future order to implement a population reduction plan, and the outcome of potential legal appeals to such an order.

Prison Construction Program

On May 3, 2007, the Governor signed AB 900 (Chapter 7, Statutes of 2007) (“AB 900”), which provides for a critical expansion of capacity in the state prison system and additional funds for county jails. In addition to construction funding, AB 900 emphasized expanding rehabilitative programs and measuring outcomes through performance goals to reduce the high rate of recidivism among adult offenders.

The central feature of AB 900 is authorization for issuance of a total of up to \$7.4 billion of lease-revenue bonds by the State Public Works Board in two phases. Prison Phase I, which may be implemented immediately, authorizes approximately \$3.6 billion to finance (i) up to 12,000 new state prison beds to replace temporary housing for inmates in public spaces not designed for such uses, (ii) up to 6,000 re-entry beds for the incarceration of inmates who have served the majority of their terms near the communities into which they will eventually be released, and (iii) facilities to provide medical, dental and mental health treatment or housing for up to 6,000 inmates. Prison Phase II may be implemented after a designated three-member panel certifies that about one-third of the spaces specified in Prison Phase I are under construction and other specified rehabilitative program requirements have been met. Prison Phase II, which must be commenced by January 1, 2014, authorizes up to approximately \$2.5 billion for (i) up to an additional 4,000 beds at existing state prisons, (ii) facilities to provide medical, dental and mental health treatment or housing for up to an additional 2,000 inmates, and (iii) up to an additional 10,000 spaces in re-entry housing.

Litigation challenging the constitutionality of the lease-revenue bond financing method included in AB 900 was dismissed by the trial court judge and the dismissal was upheld on appeal.

AB 900 also authorizes funding for acquisition, design and construction of county jail facilities, subject to a 25 percent local match and certain designated priorities and standards. Prison Phase I authorizes up to \$750 million of lease-revenue bonds for county jail facilities, which must be issued by June 30, 2017. Upon certification that certain benchmarks are met for commencement of construction under Prison Phase I and county jails, up to \$470 million in additional funds for county jails will be available under Prison Phase II.

Implementation of AB 900 has been delayed for several reasons, including the need to obtain necessary technical corrections to clarify the scope of the legislation. The Legislature passed the necessary technical corrections in February 2009 and the Administration is implementing the construction programs within the constraints of cash available for interim financing. Several projects to provide mental health capacity have been initiated and the first projects are beginning construction during calendar year 2010. Additionally, several reentry and infill projects are anticipated to begin design during calendar year 2010.

In addition to authorization for new bonds, AB 900 appropriated \$50 million from the General Fund for the CDCR to expand rehabilitative programs and \$300 million from the General Fund to complete various infrastructure and capacity improvements.

Unemployment Insurance

The Unemployment Insurance (UI) program is a federal-state program that provides weekly UI payments to eligible workers who lose their jobs through no fault of their own. To be eligible for benefits, a claimant must be able and available to work, seeking work, and be willing to accept a suitable

job. The regular unemployment program is funded by unemployment tax contributions paid by employers for each covered worker.

Due to the high rate of unemployment, the employer contributions are not sufficient to cover the cost of the benefits to claimants. In a report titled “May 20, 2010 Unemployment Insurance (UI) Fund Forecast” (the “May 2010 UI Forecast”), the state Employment Development Department stated that the UI Fund had a deficit of \$6.2 billion at the end of 2009, and projected that, absent changes to the UI Fund financing structure, the UI Fund will have deficits of \$15.3 billion at the end of 2010; and \$20.9 billion at the end of 2011. The projections in the May 2010 UI Forecast were based on an economic outlook and labor projections prepared in January 2010.

Commencing in January 2009, in accordance with federal law, the state began to fund deficits in the UI Fund through a federal loan to support benefit payments. If the loan is repaid within the federal fiscal year in which it is taken, the state does not have to pay interest on the loan. If the state is unable to repay the loan within the same year it is taken, then the state must pay interest on the borrowed funds with state funds (typically the General Fund). However, the American Recovery and Reinvestment Act (ARRA) provides that interest will not begin to accrue until January 1, 2011, and repayment to the U.S. Department of Labor would need to occur no later than September 30, 2011, or interest payments would begin as described below.

Assuming the state does not begin repayment of the loan prior to September 2011, as described above, in fiscal year 2011-12 the General Fund would be required to make an interest only payment of approximately \$554 million for the period from January 1 through September 30, 2011 (based on an assumed then outstanding federal loan of \$20.9 billion). The amount payable in fiscal years after fiscal year 2011-12 (assuming no federal waiver of the interest payment) will depend on a variety of factors, including the actual amount of the federal loan then outstanding (which in turn will depend on the rate of unemployment, employer contributions to the UI Fund, and any state or federal law changes relating to the funding of the program) and the interest rate imposed by the federal government. Congress is currently considering an extension of the interest waiver beyond December 31, 2010.

Pension Trusts

The principal retirement systems in which the state participates are the California Public Employees’ Retirement System (“CalPERS”) and the California State Teachers’ Retirement System (“CalSTRS”). The assets and liabilities of the funds administered by CalPERS and CalSTRS, as well as certain other retirement funds administered by the state, are included in the financial statements of the state as fiduciary funds. They are also described in Note 23 to the Audited Basic Financial Statements of the State of California for the Year Ended June 30, 2009. See “FINANCIAL STATEMENTS.” The University of California maintains a separate retirement system. Information about this system may be obtained directly from the University of California.

CalPERS

CalPERS administers the Public Employees’ Retirement Fund (“PERF”), which is a multiple employer defined benefit plan. In addition to the state, employer participants, as of June 30, 2009, included 1,458 school districts and 1,568 public agencies. As of June 30, 2009, PERF had 1,134,397 active and inactive program members and 492,513 benefit recipients. The projected payroll for state employees covered by PERF for fiscal year 2009-10 was approximately \$16.9 billion.

Contributions to PERF are determined annually on an actuarial basis. Payments into PERF are made from employer contributions (including the state) and employee contributions. State contributions are made from the General Fund, Special Funds, and non-governmental cost funds. Table 13 shows the state’s actual contributions to PERF for fiscal years 2005-06 through 2008-09 and estimated contributions

for fiscal years 2009-10 and 2010-11. Approximately 55 percent of the state contributions to PERF are made from the General Fund.

TABLE 13
State Contribution to
Public Employees' Retirement Fund
Fiscal Years 2005-06 to 2010-11
(Dollars in Thousands)

<u>Fiscal Year</u>	<u>Amount</u>
2005-06	\$2,402,846
2006-07	2,765,107
2007-08	2,999,455
2008-09	3,063,009
2009-10 ^(a)	3,098,000
2010-11 ^(a)	3,769,000

^(a) Estimated contributions.

Source: State of California, Department of Finance, June 21, 2010.

Employees, except those participating in the non-contributory, second tier plan contribute to PERF based upon required contribution rates. Approximately 6 percent of the employees participate in the second tier plan, and these employees generally receive lower pension benefits.

The following table is a summary of additions and deductions from PERF for the five fiscal years shown. These figures reflect activity for all employers, including the state.

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TABLE 14
Public Employees' Retirement Fund
Schedule of Additions and Deductions
(Dollars in Millions)^(a)

	Fiscal Year Ended June 30,				
	2005	2006	2007	2008	2009
Contributions: Employer	\$5,774	\$6,095	\$6,442	\$7,243	\$6,912
Contributions: Employee	3,177	3,081	3,263	3,512	3,882
Total Contributions	\$8,951	\$9,176	\$9,705	\$10,755	\$10,794
Net Investment Income/(Losses) (including Appreciation)	21,894	22,041	40,748	(12,499)	(57,367)
Total Additions	30,845	31,217	50,462	(1,738)	(46,573)
Total Deduction (Benefits Paid and Administrative Expenses)	(8,798)	(9,657)	(10,530)	(11,469)	(12,446)
Net Assets as of the Beginning of the Fiscal Year	167,584	189,631	211,191	251,123	237,915
Net Assets as of the End of the Fiscal Year	189,631	211,191	251,123	237,915	178,900
Change in Net Assets	\$22,047	\$21,560	\$39,932	\$ (13,207)	\$ (59,015)

^(a) Totals may not add up due to adjustments.

Source: CalPERS Comprehensive Annual Financial Reports, Fiscal Years Ended June 30, 2005, 2006, 2007, 2008 and 2009.

The State and Schools Actuarial Valuation for the year ended June 30, 2008 uses the Market Value of Assets ("MVA") basis to report the funded status of the system rather than the Actuarial Value of Assets ("AVA") basis as used in previous years. CalPERS is monitoring the funded status of the plan using the MVA to ensure that the new rate stabilization methods do not impair the security of benefits. The MVA funded ratios are more volatile than the actuarial funded ratios due to the smoothing effects of the actuarial value. Using the MVA basis in times when returns are profitable gives the perception of a larger funded status. However, a much lower funded status will be shown if the market slows down and returns decline. The AVA is used for rate setting purposes because it maintains some consistency over fluctuating markets through rate smoothing.

The state contributes an amount equal to the sum of the normal cost and amortization of the unfunded actuarial accrued liability, if any. Actuarial valuations of the PERF are released in the summer of each calendar year and based on data through June 30 of the preceding fiscal year. The most recent valuation, based on data through June 30, 2008, showed an accrued unfunded liability allocable to state employees of \$18.338 billion (AVA basis) and \$16.293 billion (MVA basis). The actuarial valuation for PERF was based upon an assumed 7.75 percent investment return. The weighted rates of return experienced by PERF over the past 10 years, 5 years, and 3 years (in each case through fiscal year 2007-08) has been 6.5 percent, 10.7 percent, and 8.1 percent, respectively.

The following table is a schedule of funding projections of the PERF with respect to the state's covered payroll. Actuarial information is provided on an AVA basis for each year and is based upon an actuarial valuation performed as of the end of such fiscal year.

For the six month period ended December 31, 2009, CalPERS experienced a net investment gain of 12.57 percent.

TABLE 15
Public Employees' Retirement Fund
Schedule of Funding Projections (State Only)
(Dollars in Millions)

	Fiscal Year Ended June 30,				
	2004	2005	2006	2007	2008
Actuarial Value of Assets (AVA)	\$67,081	\$71,830	\$77,143	\$83,439	\$89,304
Actuarial Accrued Liabilities	79,800	86,595	92,557	100,352	107,642
(AAL)-entry age					
Excess of Actuarial Value of Assets over AAL or Surplus (Unfunded) Actuarial Accrued Liabilities (UAAL) AVA Basis	(12,719)	(14,765)	(15,414)	(16,913)	(18,338)
Covered Payroll	12,624	12,935	13,299	14,571	15,890
Funded Ratio	84.1%	82.9%	83.4%	83.1%	83.0%

Source: CalPERS State and Schools Actuarial Valuation, Fiscal Year Ended June 30, 2004, 2005, 2006, 2007 and 2008.

The funded status set forth in Table 15 does not take into account investments returns since June 30, 2008 (including the 23 percent loss experienced in fiscal year 2008-09). In November 2009, CalPERS estimated on a preliminary basis that the funded status based on the market value of assets had at that time fallen from 84.9 percent to 55.4 percent with an unfunded actuarial liability of \$50.6 billion, based on the market value of assets and assuming a 7.75 percent rate of return. If a more conservative rate of return is assumed, then the unfunded actuarial liability would be significantly increased, and the state contribution level would increase.

Because of the rate stabilization methods adopted by the Board in April 2005 and in August 2009, the impact of current market returns, and in particular, the fiscal year 2008-09 investment loss, on employer rates for the future will be mitigated. When CalPERS sets rates, the actuarial value of assets cannot be more than 120 percent of the market value nor less than 80 percent of the market value. Any asset value changes outside these ranges will result in a greater impact on future employer contribution rates.

The negative 5.1 percent return for fiscal year 2007-08 used up about 13 percent of the 14 percent set aside for the "rainy day" fund. The remaining 1 percent was used in developing employer contribution rates for the 2009-10 fiscal year. It is important to note that, as described in CalPERS Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2008, in recent years, the demographic experience of most plans translated to increases in employer rates.

CalPERS' rate stabilization methods help to mitigate short term increases in the state's required annual contribution. While this will limit extreme increases in the state's required annual contribution to CalPERS in the near term, absent extraordinary investment returns (over and above the 7.75 percent assumed by CalPERS), it is expected to result in significantly higher required contributions in future fiscal years. Depending on actual investment returns and other factors, the state's required annual contribution (which is estimated to be \$3.5 billion for fiscal year 2010-11) could increase by 50 percent or more.

Although the investment horizon for pension plans is long term, CalPERS recognizes that investment returns over the short term fluctuate and can lead to volatile employer contribution rates, despite the current smoothing policy in place. Announced in August 2009, CalPERS has implemented an enhancement to their current rate stabilization method, which will utilize a 3-year phase-in of the negative 23 percent fiscal year 2008-09 investment loss.

According to CalPERS, the 3-year phase-in of the fiscal year 2008-09 investment loss is achieved by temporarily relaxing the constraints on the smoothed value of assets. Previously, the actuarial value of assets could not be more than 120 percent of the market value nor less than 80 percent of the market value. Under the 3-year phase in, assets are treated as follows:

1. For fiscal year 2011-12, the actuarial value of assets cannot be more than 140 percent of the market value nor less than 60 percent of the market value on June 30, 2009.
2. For fiscal year 2012-13, the actuarial value of assets cannot be more than 130 percent of the market value nor less than 70 percent of the market value on June 30, 2010.
3. For fiscal year 2013-14, the actuarial value of assets cannot be more than 120 percent of the market value nor less than 80 percent of the market value on June 30, 2011, a return to the previous values.

Lastly, the asset loss outside of the 80 percent – 120 percent will be isolated, and paid down with a fixed and certain 30 year amortization schedule. By utilizing a fixed and certain 30 year payment schedule, these losses will be paid in full at the end of 30 years, and will be independent of any investment gain/loss experienced by the remaining portfolio as a whole.

The level of future required contributions depends on a variety of other factors, including future investment portfolio performance, actuarial assumptions and additional potential changes in retirement benefits. There can be no assurances that the required annual contribution to CalPERS will not continue to significantly increase, despite the recent enhancement to rate stabilization methods, and that such increases will not materially adversely affect the financial condition of the state.

CalSTRS

CalSTRS administers the Teachers' Retirement Fund, which is an employee benefit trust fund created to administer the State Teachers' Retirement Plan ("STRP"). STRP is a cost-sharing, multi-employer, defined benefit pension plan that provides retirement, disability, and survivor benefits for teachers and certain other employees of the California public school system. STRP is comprised of three programs: the Defined Benefit Program ("DB Program"), the Defined Benefit Supplement Program ("DBS Program"), and the Cash Balance Benefit Program. Within the DB Program there is also a Supplemental Benefits Maintenance Account ("SBMA") which provides purchasing power protection for retired members. Actuarial valuations of the DB program are released in the summer of each calendar year and based on data through June 30 of the preceding fiscal year. As of June 30, 2009, the DB Program had approximately 1,745 contributing employers. As of June 30, 2008, the DB had approximately 609,375 active and inactive program members and 223,968 benefit recipients.

The state's General Fund contributions to the DB Program and the SBMA are established by statute. The contribution rate to the DB Program is currently 2.017 percent of teacher payroll for the fiscal year ending in the immediately preceding calendar year. The contribution rate to the SBMA is 2.5 percent of teacher payroll for the fiscal year ending in the immediately preceding calendar year less \$66.4 million in fiscal year 2008-09, \$70 million in fiscal year 2009-10, \$71 million in fiscal year 2010-11, and \$72 million thereafter.

The information relating to CalSTRS does not take into account any potential impact of negative investment returns of CalSTRS since June 30, 2008. CalSTRS has reported that their investment portfolio had a value of about \$131.1 billion on January 31, 2010, compared to a value of \$162.2 billion on June 30, 2008, a loss of about 19 percent.

The following table shows the state's contributions to CalSTRS for fiscal years 2005-06 through 2009-10 and its estimated contributions for fiscal year 2010-11.

TABLE 16
State Contribution To CalSTRS
Fiscal Years 2005-06 to 2010-11
(Dollars in Thousands)

Fiscal Year	DB Program	SBMA
2005-06	\$499,697	\$581,367
2006-07	360,182	598,391
2007-08	501,416	621,501
2008-09	535,603	597,474
2009-10	563,121	627,955
2010-11 ^(a)	567,707	632,653

^(a) Estimated.

Source: State of California, Department of Finance.

The following table is a summary of additions and deductions from the DB Program for the five fiscal years shown. These figures reflect activity for all employers, as well as the state's contribution.

TABLE 17
State Teachers' Retirement Defined Benefit Program Fund
Schedule of Additions and Deductions
(Dollars in Millions)^(a)

	Fiscal Year Ended June 30,				
	2005	2006	2007	2008	2009
Contributions: Employer	\$ 2,105	\$ 2,204	\$2,292	\$2,453	\$2,331
Contributions: Employee	2,327	2,231	2,335	2,512	4,547
Contributions: State ^(b)	1,219	1,019	1,078	1,630	536
Total Contributions	\$ 5,653	\$ 5,454	\$5,706	\$6,595	\$7,414
Net Investment Income/(Losses) (including Appreciation)	14,138	16,078	29,840	(9,655)	(40,400)
Total Additions	\$19,779	\$21,531	\$35,546	\$(2,847)	\$(32,986)
Total Deduction (Benefits Paid and Administrative Expenses)	(6,317)	(6,842)	(7,380)	(8,033)	(8,823)
Net Assets as of the Beginning of the Fiscal Year	116,061	129,524	144,212	172,378	161,498
Net Assets as of the End of the Fiscal Year	129,524	144,212	172,378	161,498	146,157
Change in Net Assets	\$13,462	\$14,689	\$28,166	\$(10,880)	\$(15,341)

^(a) Totals may not add up due to adjustments.

^(b) Includes federal funds.

Source: CalSTRS, Comprehensive Annual Financial Reports, Fiscal Year Ended June 30, 2005, 2006, 2007, 2008 and 2009.

Each employer contributes 8.25 percent of payroll, while employees contribute 6 percent of pay. The most recent actuarial valuation of the DB Program, based on data through June 30, 2008, showed an actuarial accrued unfunded liability of \$22.5 billion. Actuarial valuations as of June 30, 2009 are expected to be available by Summer 2010. The actuarial valuation of the DB Program is based upon an assumed 8 percent investment return. The average net rate of return experienced by the DB Program over

the past 10 years and 5 years (in each case through fiscal year 2007-08) was 11.4 percent and 7.2 percent, respectively.

The following table is a schedule for funding projections for the DB Program for the five fiscal years shown. Actuarial information is based upon actuarial valuations performed as of the end of such fiscal year. Actuarial valuations as of June 30, 2009, are expected to be available by summer 2010.

TABLE 18
State Teachers' Retirement Defined Benefit Program Fund
Schedule of Funding Projections
(Dollars in Millions)

	Fiscal Year Ended June 30,				
	2004	2005	2006	2007	2008
Actuarial Value of Assets	\$114,094	\$121,882	\$131,237	\$146,419	\$155,215
Actuarial Obligation	138,254	142,193	150,872	167,129	177,734
Unfunded Actuarial Obligation	\$(24,160)	\$(20,311)	\$(19,635)	\$(20,710)	\$(22,519)
Covered Payroll	23,764	23,293	24,263	26,202	27,384
Funded Ratio	83%	86%	87%	88%	87%

Source: CalSTRS Defined Benefit Program Actuarial Valuation as of June 30, 2004, 2005, 2006, 2007 and 2008.

Other Post-Employment Benefits (OPEB)

The state also provides post-employment health care and dental benefits to its employees and their spouses and dependents, when applicable, and recognizes these costs on a "pay-as-you-go" basis. The following table illustrates the state's budget for post-employment benefits from fiscal years 2005-06 to 2010-11 and does not reflect any future liability for current employees or annuitants. It is anticipated that these costs will continue to grow in the future.

As of June 30, 2009, approximately 141,900 retirees were enrolled to receive health benefits and 116,400 to receive dental benefits. The employer contribution for health premiums maintains the average 100/90 percent contribution formula established in the Government Code. Under this formula, the state averages the premiums of the four largest health benefit plans in order to calculate the maximum amount the state will contribute toward the retiree's health benefits. The state also contributes 90 percent of this average for the health benefits of each of the retiree's dependents. Employees vest for this benefit after serving 10 years with the state. With 10 years of service credit, employees are entitled to 50 percent of the state's full contribution. This rate increases by 5 percent per year and with 20 years of service, the employee is entitled to the full 100/90 formula.

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TABLE 19
Budget for Other Post-Employment Benefits
Fiscal Years 2005-06 through 2010-11
(Dollars in Thousands)

Fiscal Year	Amount
2005-06	\$ 895,197
2006-07	1,019,368
2007-08	1,139,495
2008-09	1,200,955
2009-10	1,207,244
2010-11	1,437,117

Source: Budget Acts of 2004, 2005, 2006, 2007 and 2008. Figures shown for fiscal years 2009-10 and 2010-11 are estimates and included in the 2010-11 May Revision.

Table 19 displays the “pay-as-you-go” contributions for health and dental benefits through fiscal year 2010-11. It is estimated that the state’s required contribution on a “pay-as-you-go” basis will be \$2.26 billion by fiscal year 2015-16.

Pursuant to the Governmental Accounting Standard Board Statement No. 45, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (“Statement No. 45”), the state now reports on its liability for post-employment healthcare as well as other forms of post-employment benefits, such as life insurance, in its annual financial reports

The long-term costs for other post-employment benefits may negatively affect the state’s financial reports and impact its credit rating if the state does not adequately manage such costs. In May 2008, the Governor released a statement endorsing the recommendations made by the Public Employee Post-Employment Benefits Commission, a group charged with identifying and comparing the advantages and disadvantages of various approaches for unfunded post-employment benefits, and proposing a plan to address unfunded post-employment benefits. Among other steps, the Governor directed the Department of Finance and the Department of Personnel Administration (“DPA”) to research and provide options to allow the state to begin pre-funding OPEB obligations, provided such a plan does not include raising taxes or dipping into the General Fund.

The Department of Finance and DPA identified four options that present opportunities for reducing the state’s current and future actuarial liabilities including the use of lower cost health plan options, active employee contributions to an OPEB trust fund, increasing the vesting period for lifetime health benefits from a graduated schedule at 10 years to 25 years, and a variety of incentives designed to promote longer careers. Implementing the recommended options concurrently could potentially reduce the state’s Actuarial Accrued Liability (“AAL”).

On February 9, 2010, the State Controller’s Office released the state’s latest OPEB actuarial valuation report by the private actuarial firm, Gabriel, Roeder, Smith & Company, tasked with calculating the state’s liability for these benefits. The report was based on a variety of data and economic, demographic and healthcare trend assumptions described in the report. The actuarial valuation contained in the report covers the cost estimates for existing employees and retirees. The main objective of the report was to estimate the AAL, which is the present value of future retiree healthcare costs attributable to employee service earned in prior fiscal years.

The report looked at three different scenarios: (i) continuation of the “pay-as-you-go” policy; (ii) a “full funding” policy under which assets would be set aside to prepay the future obligations, similar to the way in which pension obligations are funded, and (iii) a “partial funding” policy, a hybrid of the two scenarios. According to the actuarial valuation as of June 30, 2009, the current pay-as-you-go funding

policy results in an AAL of \$51.82 billion, an annual OPEB cost of \$3.93 billion, estimated employer contributions of \$1.44 billion and an expected net OPEB obligation of \$7.18 billion for fiscal 2009-10.

The key factors contributing to the \$864 million change in actuarial liabilities from the previous valuation report include:

- Healthcare claims grew at a rate lower than the assumed trend rate, resulting in a decrease in actuarial liabilities of approximately \$1.03 billion.
- Demographic experience (more members retiring earlier and living longer than assumed) caused actuarial liabilities to increase by \$601 million.
- Changes in assumptions and methods (updating the aging factors and healthcare trend rates used to project the member's average healthcare claim costs after retirement) increased actuarial liabilities by \$1.29 billion.

The valuation depended primarily on the interest discount rate assumption used to develop the present value of future benefits and on the assets available to pay benefits. The discount rate represents the long-term expectation of the earnings on the state's General Fund, which is invested in short-term securities in the Pooled Money Investment Account. The State Controller's Office plans to issue an actuarial valuation report annually.

On October 1, 2009, the Governor signed legislation that provides for prefunding OPEB for California Highway Patrol officers, including cadets, and supervisors, and managers. The contributions for prefunding OPEB were effective July 1, 2009, and are deposited in an account in the California Employers' Retiree Benefits Trust. Effective July 1, 2012, the state will match the officers' on-going cumulative contributions.

THE BUDGET PROCESS

General

The state's fiscal year begins on July 1 and ends on June 30 of the following year. The state's General Fund Budget operates on a legal basis, generally using a modified accrual system of accounting for its General Fund, with revenues credited in the period in which they are measurable and available and expenditures debited in the period in which the corresponding liabilities are incurred.

The annual budget is proposed by the Governor by January 10 of each year for the next fiscal year (the "Governor's Budget"). Under state law, the annual proposed Governor's Budget cannot provide for projected expenditures in excess of projected revenues for the ensuing fiscal year. Following the submission of the Governor's Budget, the Legislature takes up the proposal. As required by the Balanced Budget Amendment ("Proposition 58") and as described below, beginning with fiscal year 2004-05, the Legislature may not pass a budget bill in which General Fund expenditures exceed estimated General Fund revenues and fund balances at the time of the passage and as set forth in the budget bill.

Under the State Constitution, money may be drawn from the State Treasury only through an appropriation made by law. The primary source of annual expenditure appropriations is the annual Budget Act as approved by the Legislature and signed by the Governor. The Budget Act must be approved by a two-thirds majority vote of each House of the Legislature. See "Constraints on the Budget Process" below. The Governor may reduce or eliminate specific line items in the Budget Act or any other appropriations bill without vetoing the entire bill. Such individual line-item vetoes are subject to override by a two-thirds majority vote of each House of the Legislature. An initiative Constitutional amendment

has been submitted for possible inclusion on the November 2, 2010 election ballot, which would reduce the required vote to adopt a budget bill to majority from two-thirds.

Appropriations also may be included in legislation other than the Budget Act. Except as noted in the previous paragraph and in the next sentence, bills containing General Fund appropriations must be approved by a two-thirds majority vote in each House of the Legislature and be signed by the Governor. Bills containing appropriations for K-12 schools or community colleges (“K-14 education”) only require a simple majority vote. Continuing appropriations, available without regard to fiscal year, may also be provided by statute or the State Constitution.

Funds necessary to meet an appropriation are not required to be in the State Treasury at the time an appropriation is enacted; revenues may be appropriated in anticipation of their receipt.

Constraints on the Budget Process

Over the years, a number of laws and constitutional amendments have been enacted, often through voter initiatives, which have increased the difficulty of raising state taxes, restricted the use of the state’s General Fund or special fund revenues, or otherwise limited the Legislature and the Governor’s discretion in enacting budgets. Historic examples of provisions that make it more difficult to raise taxes include Proposition 13, passed in 1978, which, among other things, required that any change in state taxes enacted for the purpose of increasing revenues collected pursuant thereto, whether by increased rates or changes in computation, be approved by a two-thirds vote in each house of the Legislature. Examples of provisions restricting the use of General Fund revenues are Proposition 98, passed in 1988, which mandates that a minimum amount of General Fund revenues be spent on local education, and Proposition 10, passed in 1998, which raised taxes on tobacco products and mandated how the additional revenues would be expended. See “STATE FINANCES – Proposition 98 and K-14 Funding” and “ – Sources of Tax Revenue – Taxes on Tobacco Products.”

Recent Constitutional amendments approved by the voters have also affected the budget process. These include Proposition 58, approved in 2004, which requires the adoption of a balanced budget and restricts future borrowing to cover budget deficits; Proposition 49, approved in 2002, which requires the expansion of funding for before and after school programs; Proposition 63, approved in 2004, which imposes a surcharge on taxable income of more than \$1 million and earmarks this funding for expanded mental health services; Proposition 1A, approved in 2004, which limits the Legislature’s power over local revenue sources, and Proposition 1A approved in 2006, which limits the Legislature’s ability to use sales taxes on motor vehicle fuels for any purpose other than transportation.

These approved constitutional amendments are described below.

Balanced Budget Amendment (Proposition 58)

Proposition 58, approved by the voters in 2004, requires the state to enact a balanced budget, and establish a special reserve and restricts certain future borrowing to cover fiscal year end deficits. As a result of the provisions requiring the enactment of a balanced budget and restricting borrowing, the state would in some cases have to take more immediate actions to correct budgetary shortfalls. Beginning with the budget for fiscal year 2004-05, Proposition 58 requires the Legislature to pass a balanced budget and provides for mid-year adjustments in the event that the budget falls out of balance and the Governor calls a special legislative session to address the shortfall. The balanced budget determination is made by subtracting estimated expenditures from all resources expected to be available, including prior-year balances.

If the Governor determines that the state is facing substantial revenue shortfalls or spending increases, the Governor is authorized to declare a fiscal emergency. He or she would then be required to

propose legislation to address the emergency, and call the Legislature into special session for that purpose. If the Legislature fails to pass and send to the Governor legislation to address the fiscal emergency within 45 days, the Legislature would be prohibited from: (i) acting on any other bills or (ii) adjourning in joint recess until such legislation is passed.

Proposition 58 also requires that a special reserve BSA be established. The BSA is funded by annual transfers of specified amounts from the General Fund, unless suspended or reduced by the Governor or until a specified maximum amount has been deposited. See “STATE FINANCES – Budget Reserves.”

Proposition 58 also prohibits the use of general obligation bonds, revenue bonds, and certain other forms of borrowing to cover fiscal year end budget deficits. The restriction does not apply to certain other types of borrowing, such as: (i) short-term borrowing to cover cash shortfalls in the General Fund (including revenue anticipation notes or revenue anticipation warrants currently used by the state), or (ii) inter-fund borrowings.

Local Government Finance (Proposition 1A of 2004)

As described under “STATE FINANCES – Local Governments,” Senate Constitutional Amendment No. 4 (also known as “Proposition 1A of 2004”), approved by the voters in the November 2004 election, amended the State Constitution to, among other things, reduce the Legislature’s authority over local government revenue sources by placing restrictions on the state’s access to local governments’ property, sales, and vehicle license fee revenues as of November 3, 2004. Beginning with fiscal year 2008-09, the state is able to borrow up to 8 percent of local property tax revenues, but only if the Governor proclaims such action is necessary due to a severe state fiscal hardship and two-thirds of both houses of the Legislature approve the borrowing. The amount borrowed is required to be paid back within three years. The state also will not be able to borrow from local property tax revenues for more than two fiscal years within a period of 10 fiscal years. In addition, the state cannot reduce the local sales tax rate or restrict the authority of local governments to impose or change the distribution of the statewide local sales tax.

Proposition 1A also prohibits the state from mandating activities on cities, counties or special districts without providing for the funding needed to comply with the mandates. Beginning in fiscal year 2005-06, if the state does not provide funding for the mandated activity, the requirement on cities, counties or special districts to abide by the mandate is suspended. In addition, Proposition 1A expands the definition of what constitutes a mandate on local governments to encompass state action that transfers to cities, counties and special districts financial responsibility for a required program for which the state previously had partial or complete financial responsibility. The state mandate provisions of Proposition 1A do not apply to schools or community colleges nor to mandates relating to employee rights.

Proposition 1A further requires the state to reimburse cities, counties, and special districts for mandated costs incurred prior to fiscal year 2004-05 over a term of years. Chapter 72, Statutes of 2005 (AB 138) requires the payment of mandated costs incurred prior to fiscal year 2004-05 to begin in fiscal year 2006-07 and to be paid over a term of 15 years. The 2010-11 May Revision defers payment of these claims and refinances the balance owed over the remaining payment period. The remaining estimated cost of claims for mandated costs incurred prior to fiscal year 2004-05 is \$965.4 million.

The Amended 2009 Budget Act authorized the state to exercise its Proposition 1A borrowing authority. This borrowing generated \$1.998 billion that will be used to offset state General Fund costs for a variety of court, health, corrections, and K-12 programs. The enabling legislation also created a securitization mechanism for local governments to sell their right to receive the state’s payment obligations to a local government-operated joint powers agency (JPA). This JPA sold bonds in an aggregate amount of \$1.895 billion in November 2009 to pay the local agencies their property tax

allocations when they otherwise would receive them. Pursuant to Proposition 1A of 2004, the state is required to repay the local government borrowing (which in turn will be used to repay the bonds of the JPA) no later than June 15, 2013. The 2010-11 May Revision includes \$90.8 million for the interest payments that will be incurred in fiscal year 2010-11 to be paid from the General Fund.

See “Proposed November 2010 Initiatives – Local Government Funds” below for a description of a proposal which would substantially change the provisions of Proposition 1A of 2004.

After School Education Funding (Proposition 49)

An initiative statute, Proposition 49, called the “After School Education and Safety Program Act of 2002,” was approved by the voters on November 5, 2002, and required the state to expand funding for before and after school programs in the state’s public elementary, middle and junior high schools. The increase was first triggered in fiscal year 2006-07, which increased funding for these programs to \$550 million. These funds are part of the Proposition 98 minimum funding guarantee for K-14 education and, in accordance with the initiative, expenditures can only be reduced in certain low revenue years. See “STATE FINANCES – Proposition 98 and K-14 Funding.”

Mental Health Services (Proposition 63)

On November 2, 2004, the voters approved Proposition 63, the Mental Health Services Act, which imposes a 1 percent tax surcharge on taxpayers with annual taxable income of more than \$1 million for purposes of funding and expanding mental health services. Proposition 63 prohibits the Legislature or the Governor from redirecting funds now used for mental health services to other purposes or from reducing General Fund support for mental health services below the levels provided in fiscal year 2003-04. Additionally, Chapter 20, Statutes of 2009 makes allowable administrative changes to Proposition 63 to streamline and make more efficient administrative processes and clarifies the role of the Mental Health Services Oversight and Accountability Commission. The 2010-11 Governor’s Budget included a proposal to amend the nonsupplantation and maintenance-of-effort requirements of Proposition 63 to allow the use of Proposition 63 funds for portions of the Early and Periodic Screening, Diagnosis, and Treatment Program and the Mental Health Managed Care Program. Implementation of this proposal would have required voter approval at a general election. However, as of the 2010-11 May Revision, the Budget no longer includes this proposal.

Transportation Financing (Proposition 1A of 2006)

On November 7, 2006, voters approved Proposition 1A of 2006, which had been placed on the ballot by the Legislature as Senate Constitutional Amendment No. 7, to protect Proposition 42 transportation funds from any further suspensions. Provisions of the State Constitution enacted as Proposition 42 in 2002, permitted the suspension of the annual transfer of motor vehicle fuel sales tax revenues from the General Fund to the Transportation Investment Fund if the Governor declared that the transfer would result in a “significant negative fiscal impact” on the General Fund and the Legislature agreed with a two-thirds vote of each house. The new measure modified the constitutional provisions of Proposition 42 in a manner similar to Proposition 1A of 2004, so that if such a suspension were to have occurred, the amount owed by the General Fund would have had to be repaid to the Transportation Investment Fund within three years, and only two such suspensions could have been made within any 10-year period. In fiscal year 2003-04, \$868 million of the scheduled Proposition 42 transfer was suspended, and in fiscal year 2004-05 the full transfer of \$1.258 billion was suspended. Budget Acts for fiscal years 2006-07, 2007-08 and 2008-09 all fully funded the Proposition 42 transfer and partially repaid the earlier suspensions. The Amended 2009 Budget Act fully funded the Proposition 42 transfer in fiscal year 2009-10 at \$1.433 billion with another \$83 million to repay a portion of past suspensions. Chapter 11, Statutes of 2010, in the Eighth Extraordinary Session eliminated the General Fund sales tax on gasoline that funded the Proposition 42 Transfer, and replaced it with increased fuel excise tax revenues that go

directly to local governments for road maintenance and to the State Highway Account for highway maintenance and rehabilitation projects. See “AMENDED 2009 BUDGET ACT.”

See “Proposed November 2010 Initiatives – Local Government Funds” below for a description of a proposal which would substantially modify funding of transportation.

Proposed November 2010 Initiatives

Proponents have filed a number of initiative petitions with the Secretary of State for inclusion on the November 2, 2010 ballot of measures which would affect the budget process described previously in this section of Appendix A. Currently, the Secretary of State is sampling to determine if the required number of valid signatures for each proposal has been submitted. The Secretary of State is expected to announce by June 24 or June 25, 2010 (after the date of this Official Statement) which measures have qualified; for some measures, counting of signatures may continue after this deadline and the measures may eventually be qualified for the next statewide election after November 2, 2010.

Local Government Funds

A measure called the “Local Taxpayer, Public Safety and Transportation Protection Act of 2010” has qualified for the November 2, 2010 ballot. If adopted, this measure would reverse Proposition 1A of 2004 and prohibit any future action by the Legislature to take, reallocate or borrow money raised by local governments for local purposes, and would prohibit changes in the allocation of property taxes among local governments designed to aid state finances. The Proposition 1A borrowing done in 2009 would be grandfathered. In addition, the state would be prohibited from borrowing sales taxes or excise taxes on motor vehicle fuels or changing the allocations of those taxes among local governments except pursuant to specified procedures involving public notices and hearings. Any law enacted after October 29, 2009 inconsistent with the new law would be repealed.

Increases in Taxes or Fees

This measure would revise provisions in Articles XIII A and XIII C of the Constitution dealing with tax increases. The measure would specify that a two-thirds vote of both houses of the Legislature is required for any increase in any tax on any taxpayer, eliminating the current practice where a tax increase coupled with a tax reduction is treated as being able to be adopted by majority vote. Furthermore, any increase in a fee beyond the amount needed to provide the specific service or benefit would be a tax requiring two-thirds vote. Finally, any tax adopted after January 1, 2010 with a majority vote which would have required a two-thirds vote if the measure were in place would be repealed after one year from the election date unless readopted by the necessary two-thirds vote.

Majority Vote for Budget

This measure would change the present requirement of a two-thirds vote for adoption of a budget bill to a majority vote of each house. It would not change the two-thirds vote requirement for adoption of increased taxes.

Legalization of Sale of Marijuana

This proposal has been certified for the November 2010 ballot, and would legalize the possession and sale of certain amounts of marijuana in the state. If these sales were subject to taxation, the state would obtain additional revenue.

Two other measures also submitted for qualification for the November ballot involve changes in state revenues, and are discussed above under “STATE FINANCES – Sources of Tax Revenues.”

PRIOR FISCAL YEARS' BUDGETS

Fiscal Years Prior to 2007-08

Following a half decade of strong economic and revenue growth in the late 1990s and into 2000, during fiscal year 2001–02, as the state and national economies fell into a recession and the stock markets dropped significantly, the state experienced an unprecedented drop in revenues compared to the prior year largely due to reduced personal income taxes from stock option and capital gains activity. During the three fiscal years between 2001-02 and 2003-04, the state encountered severe budgetary difficulties because of reduced revenues and failure to make equivalent reductions in expenditures, resulting in successive budget deficits. The budgets for these years included substantial reliance on one-time measures, internal borrowing, and external borrowing. The state also faced a cash flow crisis during this period which was relieved by the issuance of RAWs in June 2002 and June 2003 and ERBs in the spring of 2004. See “STATE INDEBTEDNESS AND OTHER OBLIGATIONS.”

The state's economy rebounded strongly during the 2004-05, 2005-06 and 2006-07 fiscal years, with the result that General Fund revenues were substantially higher in each year than had been projected at the start of the year. This allowed the budgets in these years to end with substantial positive balances (although the positive balance declined from approximately \$9.9 billion at the end of fiscal year 2005-06 to approximately \$3.5 billion at the end of fiscal year 2006-07). The state continued to utilize a combination of expenditure cuts, cost avoidance, internal and external borrowing, fund shifts, and one-time measures such as securitization of tobacco settlement revenues and sale of ERBs, to produce balanced budgets. The 2005 Budget Act had much less reliance on one-time measures than the budgets of the immediately preceding years, but did include receipt of \$525 million from refinancing of tobacco securitization bonds.

Final estimates relating to the 2006-07 fiscal year, as released in the 2007-08 Governor's Budget in January 2008, showed that the state experienced more favorable results than were projected at the time the 2006 Budget Act was signed. As a result of revised estimates for years prior to fiscal year 2005-06 and improved economic results which generated increases in tax revenues, the Administration estimated that the fund balance at June 30, 2006 was about \$3.487 billion, of which \$3.0 billion was in the SFEU, compared to the original 2006 Budget Act estimate of \$1.6 billion in the SFEU.

Additional information about prior fiscal years' budgets for this period can be obtained from prior official statements of state bonds.

2007 Budget Act

The 2007 Budget Act was adopted by the Legislature on August 21, 2007, along with a number of implementing measures, and signed by the Governor on August 24, 2007. In approving the budget the Governor vetoed \$943 million in appropriations from the General Fund, Special Funds, and bond funds (including \$703 million in General Fund appropriations).

The 2007 Budget Act included the largest reserve of any budget act in the state's history, a total of \$4.1 billion. The reserve was made so large because the 2007 Budget Act contained a number of risks. By the time of the 2008-09 Governor's Budget, released on January 10, 2008, it had become clear that many of these risks had in fact occurred, and that even the planned reserve would not be enough to keep the budget in balance through June 30, 2008. Accordingly, the Governor called a special session of the Legislature which took a series of actions to close the budget gap, and the Governor took certain additional actions not requiring legislative action.

Under the 2007 Budget Act as originally enacted, General Fund revenues and transfers were projected to increase 6.0 percent, from \$95.5 billion in fiscal year 2006-07 to \$101.2 billion in fiscal year

2007-08. The 2007 Budget Act contained General Fund appropriations of \$102.3 billion, compared to \$101.7 billion in fiscal year 2006-07. The June 30, 2008 total reserve was projected to be \$4.1 billion. See “STATE FINANCES – Budget Reserves – Budget Stabilization Account” for an explanation of the budgetary reporting method for revenues.

2008 Budget Act

After an extended delay, the 2008 Budget Act was adopted by the Legislature on September 16, 2008, along with a number of implementing measures, and signed by the Governor on September 23, 2008. In approving the budget, the Governor vetoed \$714 million in appropriations from the General Fund, Special Funds, and bond funds (including \$510 million in General Fund appropriations).

The 2008 Budget Act as originally enacted, resolved the \$17.3 billion budget deficit (after implementation of the \$7.0 billion in actions taken during the February 2008 fiscal emergency special session of the Legislature) identified in the 2008-09 May Revision. It provided a modest reserve of \$1.7 billion for fiscal year 2008-09, but projected a deficit of \$1.0 billion in fiscal year 2009-10.

Under the 2008 Budget Act as originally enacted, General Fund revenues and transfers were projected to decrease 1.0 percent, from \$103.0 billion in fiscal year 2007-08 to \$102.0 billion in fiscal year 2008-09. The 2008 Budget Act contained General Fund appropriations of \$103.4 billion, compared to \$103.3 billion in fiscal year 2007-08. The June 30, 2009 total reserve was projected to be \$1.7 billion, a decrease of \$1.4 billion or 45 percent compared to the June 30, 2008 reserve. See “STATE FINANCES – Budget Reserves – Budget Stabilization Account” for an explanation of the budgetary reporting method for revenues. The February 2009 Budget Package made major changes to the 2008 Budget Act. See Table 20 for the fiscal year 2008-09 estimated General Fund budget summary.

The 2008 Budget Act as originally enacted, contained the following major General Fund components:

1. Budget Reform – The Governor’s highest budget priority for fiscal year 2008-09 was to enact reforms in the state’s budget system. In response, the Legislature approved an historic constitutional amendment, to be considered by the people on the next statewide ballot after November 2008. (The February 2009 Budget Package provided for a revised version of budget reform, Proposition 1A of 2009, that was included in the May 19, 2009 special election. The voters rejected this measure.)
2. Addressing the Deficit – The 2008 Budget Act resolved the \$17.3 billion budget deficit for the combined 2007-08 and 2008-09 fiscal years identified in the 2008-09 May Revision (after implementation of the \$7.0 billion in actions taken during the February 2008 fiscal emergency special session of the Legislature described below) and provided a modest reserve of \$1.7 billion for fiscal year 2008-09 in part via \$8.0 billion in expenditure reductions which account for 46 percent of all solutions. As a result of these reductions, this budget intended to hold General Fund spending to virtually no growth in fiscal year 2008-09, \$103.4 billion in fiscal year 2008-09 compared to \$103.3 billion in fiscal year 2007-08. Additional solutions included \$8.4 billion in revenue increases, \$700 million in borrowing, and a reduction in the reserve of \$306 million. The following were the major elements of the \$8.4 billion revenue increase: Corporate Penalty for Understatement of Tax (\$1.510 billion), Net Operating Loss Suspension and Carryback (\$1.265 billion), Tax Credit Limitation and Usage Modification (\$615 million), Limited Liability Corporations Payment Date Change (\$360 million), Accelerated Estimated Payments (\$1.270 billion), Remove Estimated Payment Option for High Income Taxpayers (\$1.035 billion), and Accrual Change (\$1.856 billion). See “STATE FINANCES – Sources of Tax Revenue.” The 2008 Budget Act also contained transfers and loans of \$855 million to the General Fund from various Special Funds; savings of \$340 million from the delay in enactment of the 2008 Budget

Act and an Executive Order by the Governor reducing the use of certain part-time state employees; use of \$500 million of sales taxes on gasoline to offset certain General Fund costs associated with transportation activities; and \$200 million of certain other one-time budgetary actions. Of the \$24.3 billion budget deficit identified in the 2008-09 May Revision, \$7.0 billion (including the \$3.313 billion issuance of Economic Recovery Bonds) of the deficit was addressed in February 2008 during a Fiscal emergency special session.

3. Cash Flow Management – Under the 2008 Budget Act, the Legislature approved a plan to improve cash management to smooth cash flow imbalances and to reduce the amount of external borrowing the state needed to meet its cash needs in fiscal year 2008-09. To smooth out the cash flow imbalances, certain payments for the following programs were shifted during the year: Education (K-12, excluding Child Development), the University of California, Community Colleges, the Williamson Act, and Citizens' Option for Public Safety/Juvenile Justice Crime Prevention Act. The plan was intended to reduce the amount of external borrowing by \$3 billion to \$4 billion in fiscal year 2008-09, and was expected to result in savings of tens of millions of dollars, depending on interest rates and external borrowing issuance timing.
4. Proposition 98 – The Proposition 98 Guarantee for fiscal year 2008-09 was projected to grow to \$58.1 billion, which is \$1.3 billion above the 2008-09 May Revision. The 2008 Budget Act appropriates \$58.1 billion, of which \$41.9 billion is from the General Fund and \$16.1 billion is from local revenue. See "STATE FINANCES – Proposition 98 and K-14 Funding."
5. K-12 Education – Total expenditures from all sources for K-12 education programs in fiscal year 2008-09 were projected to be \$71.9 billion (\$42 billion General Fund). This reflected an increase of \$3.4 billion over the 2008-09 Governor's Budget. Total per-pupil expenditures were projected to increase by \$110 to \$12,152 in fiscal year 2008-09 compared with the fiscal year 2007-08 level, which includes funds provided for prior year settle-up obligations.
6. Higher Education – The 2008 Budget Act reflected a total funding level of \$20.7 billion, including \$14.2 billion from General Fund and Proposition 98 sources for all major segments of Higher Education (excluding infrastructure and stem cell research) after budget-balancing reductions and other policy reductions. This reflected an increase of \$751.3 million (including \$386 million from General Fund and Proposition 98 sources) above the revised 2007-08 level.
7. Health and Human Services – The 2008 Budget Act included \$31 billion from General Fund for Health and Human Services programs, which is an increase of \$1.6 billion from the revised fiscal year 2007-08 estimate. Total funding from all state funds for Health and Human Services programs was \$39.4 billion. The major General Fund workload adjustments included the following: (a) an increase of \$556.7 million in the CalWORKs program, primarily due to depletion of federal funding that has historically been carried over from year to year; (b) an increase of \$187.7 million for health programs and an increase of \$52.5 million for human services programs attributable to enrollment, caseload, and population driven changes; (c) an increase of \$169.8 million for required managed care rate adjustments; and (d) an increase of \$22.4 million for statutorily required COLAs for Skilled Nursing Facilities. The 2008 Budget Act reflected expenditure reductions due to policy adjustments, including (a) \$985.8 million from reducing provider payment rates in the Medi-Cal program; (b) \$313.3 million for fully suspending the June 2008 and June 2009 state COLAs from the Supplemental SSI/SSP program; (c) \$171.9 million from fully suspending the July 2008 COLA for the CalWORKs program; and (d) \$22.5 million from placing limitations on the rates managed care plans pay to non-contract hospitals for emergency care services in the Medi-Cal program.

8. Transportation Funding – The 2008 Budget Act included \$1.42 billion to fully fund Proposition 42 in fiscal year 2008-09. Proposition 1A was passed in November 2006 and provides for the repayment of any remaining Proposition 42 debt by the fiscal year 2015-16. Pursuant to Proposition 1A, the 2008 Budget Act repays \$83 million from the fiscal years 2003-04 and 2004-05 Proposition 42 suspensions. Because the issuance of tribal gaming bonds continues to be delayed, the Governor’s Budget proposed to use the \$100 million in tribal gaming compact revenues received in fiscal year 2008-09 until the bonds are sold, to repay past loans made from the State Highway Account and the Traffic Congestion Relief Fund. Proposition 1B was also passed in November 2006, providing \$19.9 billion in bonding authority for a total of 16 programs intended to address a broad range of transportation priorities including rehabilitation and expansion of highways, transit and transit security, port security, and air quality. The authority for the use of any bond funds must be provided for in the Budget Act. The 2008 Budget Act appropriated \$4.7 billion in Proposition 1B funding. The 2008 Budget Act also appropriated \$1.5 billion in General Fund relief from sales tax revenues, including revenues from the “spillover” (the amount that gasoline sales tax revenues at the 4.75 percent rate exceed the amount generated from sales tax on all other goods at the 0.25 percent rate). Of this amount, \$593 million was redirected from local transit grants through the State Transit Assistance program to reimburse the General Fund for its Home-to-School Transportation and state special schools costs out of the Public Transportation Account. Additionally, the remaining \$939 million was redirected from both local transit grants and state capital projects to reimburse the General Fund for debt service payments made on transportation bonds in past years.
9. Budget Stabilization Account – Under normal circumstances, the state would set aside \$1.509 billion for fiscal year 2008-09 in the BSA for rainy day purposes. Given the \$24.3 billion budget deficit, the 2008 Budget Act suspended this transfer to the BSA for the 2008-09 fiscal year.
10. Modernization and Securitization of the California Lottery - The 2008 Budget Act included legislation (which was further modified in the February 2009 Budget Package) to modernize and permit securitization of revenues from the State Lottery, but this proposal was rejected by the voters on May 19, 2009.

Fiscal Year 2008-09 Revised Estimates in the Amended 2009 Budget Act

Since the enactment of the 2008 Budget Act, economic conditions in the state worsened considerably from projections, as described under “STATE FINANCIAL PRESSURE.” The 2009-10 Governor’s Budget projected that the state would end fiscal year 2008-09 with no reserve, compared to the original estimate of \$1.7 billion at the time of the 2008 Budget Act. Subsequent projections prepared in connection with the Initial 2009 Budget Act estimated a total reserve deficit on June 30, 2009 of \$3.4 billion, down \$5.1 billion from the 2008 Budget Act estimate.

Given the dramatic decline in General Fund revenues and the emergence of a \$41.6 billion combined current and budget year General Fund gap, the Governor called three special sessions of the Legislature on November 6, December 1, and December 19, 2008 to take actions on various budget items in order to reduce expenditures in fiscal year 2008-09 and address the state’s cash shortage. The Legislature passed on February 19, 2009 and the Governor signed on February 20, 2009, the Initial 2009 Budget Act that addressed the combined deficit of \$41.6 billion in fiscal years 2008-09 and 2009-10. See “STATE FINANCIAL PRESSURE” and “AMENDED 2009 BUDGET ACT.”

As the recession deepened throughout the spring, revenues continued to erode and the budget had again fallen out of balance. On July 1, 2009 the Governor declared a fiscal emergency and called a special session of the Legislature to solve the new \$24.3 billion deficit. The Legislature passed on July 24, 2009 and the Governor signed on July 28, 2009 the Amended 2009 Budget Act.

The prior year's resources available balance in the Amended 2009 Budget Act reflected a net increase of \$72 million for fiscal year 2008-09 since the 2008 Budget Act. This balance was primarily made up of the following components:

- \$807.3 million net increase in revenues in fiscal years 2007-08 and 2008-09;
- \$397.6 million increase in Proposition 98 expenditures in fiscal year 2007-08;
- \$1.580 billion increase in prior year Proposition 98 settle-up payments;
- \$1.209 billion decrease in non-Proposition 98 expenditures; and
- \$33.4 million increase to beginning balance for fiscal year 2006-07 and prior adjustments.

As of the adoption of the Amended 2009 Budget Act, General Fund revenues and transfers for fiscal year 2008-09 were projected at a revised \$84.1 billion, a decrease of \$17.9 billion compared with 2008 Budget Act estimates. This change is primarily made up of the following components:

- \$10.4 billion decrease in personal income tax;
- \$3.3 billion decrease in corporation tax;
- \$2.5 billion decrease in sales and use tax;
- \$1.9 billion decrease in miscellaneous revenues; and
- \$231.8 million increase in transfers and loans.

Under the Amended 2009 Budget Act, General Fund expenditures for fiscal year 2008-09 were projected at \$91.5 billion, a decrease of \$11.9 billion compared with 2008 Budget Act estimates. This primarily included a decrease of \$10.4 billion in expenditure reductions offset by, among other things, \$2.8 billion of federal stimulus funds and \$1.5 billion in increased taxes.

The following table shows the estimated General Fund Budget Summary for fiscal year 2008-09 as originally projected by the 2008 Budget Act, as subsequently revised by the 2009-10 Governor's Budget, and as further revised by the Amended 2009 Budget Act.

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Budget Summary for Fiscal Year 2008-09

TABLE 20
2008-09 Estimated General Fund Budget Summary
(Dollars in Millions)

	As of 2008 Budget Act (September 16, 2008)	As of 2009-10 Governor's Budget (December 31, 2008)	As of Amended 2009 Budget Act (July 28, 2009)
Prior Year Resources Available	\$3,999 ^(a)	\$2,375 ^(a)	\$4,071 ^(a)
Revenues and Transfers	101,991	91,117	84,097
Expenditures	103,401	92,413	91,547
Fund Balance	\$2,589	\$1,079	\$(3,379)
Reserve for Liquidation of Encumbrances	\$885	\$1,079	\$1,079
Special Fund for Economic Uncertainties	\$1,703	--	\$(4,458)
Budget Stabilization Account	--	--	--
Total Available Reserve	\$1,703	--	\$(4,458)

^(a) Includes a carry-over adjustment of \$1.34 billion from amnesty-related payments, of which \$960 million will have to be refunded or will reduce revenues in future years, including a \$250 million adjustment in fiscal year 2008-09 and \$710 million in fiscal year 2009-10 or later.

Source: State of California, Department of Finance.

FINANCIAL STATEMENTS

The Audited Basic Financial Statements of the State of California for the Year Ended June 30, 2009 (the "Financial Statements") are available and incorporated by reference in this APPENDIX A. The Financial Statements consist of an Independent Auditor's Report, a Management Discussion and Analysis, Basic Financial Statements of the state for the Year Ended June 30, 2009 ("Basic Financial Statements"), and Required Supplementary Information. Only the Basic Financial Statements have been audited, as described in the Independent Auditor's Report. A description of the accounting and financial reporting standards set by the Governmental Accounting Standards Board and used in the Basic Financial Statements is contained in Note 1 of the Basic Financial Statements.

A copy of the Financial Statements may also be obtained or reviewed from the following sources:

1. By obtaining, from Municipal Securities Rulemaking Board's Electronic Municipal Market Access website or from any other source, a copy of the State of California's Official Statement dated March 11, 2010 for \$2,500,000,000 Various Purpose General Obligation Bonds. The Financial Statements are printed in full in such Official Statement. No other part of the March 11, 2010 Official Statement is incorporated into this document except the Financial Statements.

2. By accessing the internet website of the State Controller (www.sco.ca.gov), selecting "Publications," "State Government Reports" and then selecting "State Government Annual Financial Reports," or by contacting the Office of the State Controller at (916) 445-2636.

3. By accessing the internet website of the State Treasurer (www.treasurer.ca.gov) and under the heading “Bond Finance,” select “Public Finance Division” and then select “Recent Financial Information” or by contacting the Office of the State Treasurer at (800) 900-3873.

The State Controller issues a monthly report on General Fund cash receipts and disbursements. These reports are available on the State Controller’s website, and are normally released on the 10th day of every calendar month for the period ended on the last day of the prior month. The State Controller’s unaudited reports of General Fund cash receipts and disbursements for the period after June 30, 2009 is included as EXHIBIT 1 to this APPENDIX A.

Periodic reports on revenues and/or expenditures during the fiscal year are issued by the Administration, the State Controller’s Office and the LAO. The Department of Finance issues a monthly bulletin, available by accessing the internet website of the Department of Finance (www.dof.ca.gov), which reports the most recent revenue receipts as reported by state departments, comparing those receipts to budget projections. The Administration also formally updates its budget projections three times during each fiscal year, in January, May, and at the time of budget enactment. These bulletins and reports are available on the internet at websites maintained by the agencies and by contacting the agencies at their offices in Sacramento, California. Such bulletins and reports are not part of or incorporated into this APPENDIX A. Investors are cautioned that interim financial information is not necessarily indicative of results for a fiscal year. Information which may appear in this APPENDIX A from the Department of Finance concerning monthly receipts of “agency cash” may differ from the State Controller’s reports of cash receipts for the same periods because of timing differences in the recording of in-transit items.

INVESTMENT OF STATE FUNDS

Moneys on deposit in the State Centralized Treasury System are invested by the State Treasurer in the PMIA. As of May 31, 2010, the PMIA held approximately \$48.3 billion of state moneys, and \$23.7 billion invested for about 2,786 local governmental entities through the Local Agency Investment Fund (“LAIF”). The assets of the PMIA as of May 31, 2010 are shown in the following table.

TABLE 21
Analysis of Pooled Money Investment Account Portfolio^(a)
(Dollars In Thousands)

Type of Security	Amount	Percent of Total
U.S. Treasuries	\$35,073,454	48.74%
Federal Agency Debentures	2,068,975	2.88
Certificate of Deposit	6,325,020	8.79
Bank Notes	500,000	0.69
Federal Agency Discount Notes	4,922,917	6.84
Time Deposits	4,054,640	5.63
GNMAs	74	0.00
Commercial Paper	7,817,116	10.87
FHLMC/Remics	692,696	0.96
Corporate Bonds	125,120	0.17
AB 55 Loans	285,434	0.40
GF Loans	9,795,800	13.61
Other	<u>300,000</u>	<u>0.42</u>
Total	\$71,961,246	100.00%

^(a) Totals may not add due to rounding.

Source: State of California, Office of the State Treasurer.

The State's Treasury operations are managed in compliance with the California Government Code and according to a statement of investment policy which sets forth permitted investment vehicles, liquidity parameters and maximum maturity of investments. The PMIA operates with the oversight of the PMIB. The LAIF portion of the PMIA operates with the oversight of the Local Agency Investment Advisory Board (consisting of the State Treasurer and four other appointed members).

The PMIA does not now invest, nor has it ever invested, in Structured Investment Vehicles ("SIVs") or Collateralized Debt Obligations ("CDOs"). In keeping with full transparency of the PMIA portfolio performance, the PMIA's holdings are displayed quarterly on the State Treasurer's website and may be accessed under PMIB Quarterly Reports. The PMIA does not currently invest in auction rate securities.

The State Treasurer does not invest in leveraged products or inverse floating rate securities. The investment policy permits the use of reverse repurchase agreements subject to limits of no more than 10 percent of the PMIA. All reverse repurchase agreements are cash matched either to the maturity of the reinvestment or an adequately positive cash flow date which is approximate to the maturity of the reinvestment.

The average life of the investment portfolio of the PMIA as of May 31, 2010 was 182 days.

OVERVIEW OF STATE GOVERNMENT

Organization of State Government

The State Constitution provides for three separate branches of government: the legislative, the judicial and the executive. The Constitution guarantees the electorate the right to make basic decisions, including amending the Constitution and local government charters. In addition, the state voters may directly influence state government through the initiative, referendum and recall processes. The Constitution provides for mechanisms through which it may be amended or revised.

California's Legislature consists of a forty-member Senate and an eighty-member Assembly. Assembly members are elected for two-year terms, and Senators are elected for four-year terms. Assembly members are limited to three terms in office and Senators to two terms. The Legislature meets almost year round for a two-year session. The Legislature employs the Legislative Analyst, who provides reports on state finances, among other subjects. The Bureau of State Audits, headed by the State Auditor, an independent office since 1993, annually issues an auditor's report based on an examination of the General Purpose Financial Statements of the State Controller, in accordance with generally accepted accounting principles. See "FINANCIAL STATEMENTS."

The Governor is the chief executive officer of the state. The Governor presents the annual budget and traditionally presents an annual package of bills constituting a legislative program. In addition to the Governor, state law provides for seven other statewide elected officials in the executive branch. The Governor and the other statewide officials may be elected for up to two four-year terms. The current elected statewide officials, their party affiliation and the dates on which they were first elected are as follows:

<u>Office</u>	<u>Name</u>	<u>Party Affiliation</u>	<u>First Elected</u>
Governor	Arnold Schwarzenegger	Republican	2003
Lieutenant Governor	Abel Maldonado*	Republican	2010
Controller	John Chiang	Democrat	2006
Treasurer	Bill Lockyer	Democrat	2006
Attorney General	Edmund G. Brown Jr.	Democrat	2006
Secretary of State	Deborah Bowen	Democrat	2006
Superintendent of Public Instruction	Jack O'Connell	Democrat	2002
Insurance Commissioner	Steve Poizner	Republican	2006

The executive branch is principally administered through eighteen major agencies and departments: Business, Transportation and Housing Agency, Department of Corrections and Rehabilitation, Office of the Secretary of Education, Environmental Protection Agency, Department of Finance, Department of Food and Agriculture, Health and Human Services Agency, Labor and Workforce Development Agency, Natural Resources Agency, Office of the State Chief Information Officer, Secretary of Service and Volunteering, State and Consumer Services Agency, Department of Veterans Affairs, Emergency Management Agency, Arts Council, Office of the Inspector General, Military Department, and State Public Defender. In addition, some state programs are administered by boards and commissions, such as The Regents of the University of California, Public Utilities Commission, Franchise Tax Board and California Transportation Commission, which have authority over certain functions of state government with the power to establish policy and promulgate regulations. The appointment of members of boards and commissions is usually shared by the Legislature and the Governor, and often includes ex officio members.

Higher Education

California has a comprehensive system of public higher education comprised of three segments: the University of California, the California State University System and California Community Colleges. The University of California provides undergraduate, graduate and professional degrees to students. Approximately 58,865 degrees were awarded in the 2008-09 school year. Approximately 232,091 full-time students were enrolled at the ten University of California campuses and the Hastings College of Law in the 2009-10 school year. (The newest campus, at Merced, opened to graduate students in 2004 and to undergraduates in the fall of 2005.) The California State University System (CSU) provides undergraduate and graduate degrees to students. Approximately 93,654 degrees were awarded in the 2008-09 school year. The CSU estimates that about 355,762 full-time students were enrolled at the 23 campuses in the 2009-10 school year. The third sector consists of 110 campuses operated by 72 community college districts, which provide associate degrees and certificates to students. Additionally, students may attend community colleges to meet basic skills and other general education requirements prior to transferring to a four-year undergraduate institution. About 133,689 associate degrees and certificates were awarded in the 2008-09 school year. More than 1.7 million students were enrolled in California Community Colleges in the spring of 2009.

Employee Relations

According to the Department of Personal Administration, as of November 30, 2009, the state work force was comprised of approximately 359,000 personnel years ("PYs"), of which approximately 122,000 PYs represented state employees of the legislative and judicial branches of government, and institutions of higher education. Of the remaining 237,000 PYs, approximately 193,000 were subject to collective bargaining and approximately 44,000 were excluded from collective bargaining. State law provides that state employees, defined as any civil service employee of the state and teachers under the jurisdiction of the Department of Education or the Superintendent of Public Instruction, and excluding

* Appointed to fill the remaining term of the previous Lieutenant Governor, who resigned to take a seat in Congress.

certain other categories, have a right to form, join, and participate in the activities of employee organizations for the purpose of representation on all matters of employer-employee relations. Once a bargaining unit selects an employee organization, only that organization can represent those employees.

The scope of representation is limited to wages, hours, and other terms and conditions of employment. Representatives of the Governor are required to meet and confer in good faith and endeavor to reach agreement with the employee organization, and, if agreement is reached, to prepare a memorandum of understanding and present it to the Legislature for ratification. The Governor and the recognized employee organization are authorized to agree mutually on the appointment of a mediator for the purpose of settling any disputes between the parties, or either party could request the Public Employment Relations Board to appoint a mediator.

There are 21 collective bargaining units that represent state employees. The Service Employees International Union ("SEIU") is the exclusive representative for 9 of the 21 collective bargaining units, or approximately 50 percent of those represented employees subject to collective bargaining. The International Union of Operating Engineers is the exclusive representative for two of the 21 collective bargaining units. The remaining bargaining units each have their own exclusive representative.

Of the 21 bargaining units, only the California Association of Highway Patrolmen ("CAHP") has a contract in effect, which expires July 2, 2010. Seventeen of the 20 contracts expired in June 2008 and one ended in July 2008. The California Attorneys, Administrative Law Judges and Hearing Officers in State Employment have been working without a contract since June 30, 2007. The California Correctional Peace Officers Association has been without a contract since July 2, 2006.

As part of the Amended 2009 Budget Act and pursuant to Executive Orders S-16-08 and S-13-09, the state is implementing a three-day per-month furlough from July 1, 2009 through June 30, 2010 for all state civil service employees with the exception of those in Bargaining Unit 5 (Highway Patrol Officers), Highway Patrol Dispatchers, the Bureau of State Audits, the Legislative Counsel Bureau, and the Department of Forestry and Fire Protection. This is estimated to result in a savings of \$2.2 billion (\$1.3 billion General Fund) in fiscal year 2009-10. The elimination of two holidays (Lincoln's Birthday and Columbus Day) and premium pay for hours worked on all remaining holidays as of February 2009 is estimated to result in savings of \$76.6 million (\$74.5 million General Fund) in fiscal year 2009-10. The revised methodology of calculating overtime based on actual time worked (excludes leave from overtime calculations), also implemented in February 2009, is estimated to result in savings of \$56.5 million (\$48 million General Fund) in fiscal year 2009-10. In addition, as a part of the 2010-11 May Revision, the Administration proposes to:

- Implement a five percent workforce cap through increased salary savings that is estimated to result in savings of \$802.4 million (\$449.6 million General Fund).
- Implement a five percent salary reduction on civil service employees that is estimated to result in savings of \$945.3 million (\$529.6 million General Fund).
- Increase civil service employee retirement contributions by five percent and decrease employer retirement contributions by five percent to save an estimated \$724.2 million (\$405.8 million General Fund).
- Implement a one-day-per-month personal leave program for all state civil service employees from July 1, 2010 until June 30, 2011 that is estimated to result in savings of \$795.5 million (\$445.7 million General Fund).

Subsequent to the 2010-11 May Revision, the Administration has entered into tentative contract agreements with representatives of bargaining units 5 (CAHP representing 6,660 employees), 8 (California Department of Forestry Firefighters representing 4,280 employees), 18 (California Association of Psychiatric Technicians representing 6,543 employees), and 19 (American Federation of State, County and Municipal Employees representing 5,407 employees). These tentative agreements still require ratification by union members and the Legislature. Provisions of the contracts include:

- Reduced pension benefits for new hires (bargaining units 5, 8, 18, and 19).
- Increased pension contributions for existing employees of 2 percent, 4 percent, 5 percent, and 5 percent for bargaining units 5, 8, 18, and 19, respectively.
- Restructured pay scales that add a top step of 2 percent, 4 percent, 5 percent, and 5 percent for bargaining units 5, 8, 18, and 19, respectively in 2012.
- Revision of the salary calculation for pension benefits to be based on the average salary of the three-highest-years for new employees instead of the current single-highest-year (bargaining units 5 and 8).
- Protection from furloughs and from minimum wage when a budget is not signed by July 1 (bargaining units 5, 8, 18, and 19).
- A one-day-per-month unpaid personal leave program during the 2010-11 fiscal year (bargaining units 18 and 19).
- Revised employer health care premium payment (bargaining unit 18)
- Use of leave time in calculating overtime (bargaining units 8 and 18)
- Revised premium pay policies so that employees earn time-and-a-half instead of straight time when working on 6 of 11 state holidays (bargaining units 18 and 19)

It is estimated that these contracts would save the state \$72 million (\$43 million General Fund) in fiscal year 2010-11. This generally represents a portion of the proposed savings put forth in the 2010-11 May Revision associated with increased pension contributions and the unpaid personal leave program.

ECONOMY AND POPULATION

Introduction

California's economy, the largest among the 50 states and one of the largest in the world, has major components in high technology, trade, entertainment, agriculture, manufacturing, tourism, construction and services. A housing downturn that began in California in the fall of 2005 and worsened in 2006 and 2007 was instrumental in slowing average monthly job growth from 27,200 in 2005 to 5,300 in 2007 to a negative (job loss) of 57,100 per month in 2008 and 2009. See "2010-11 PROPOSED GOVERNOR'S BUDGET AND THE 2010-11 MAY REVISION – Current Economic Conditions."

On February 27, 2009, the Governor proclaimed a state of emergency due to statewide drought conditions in California. The drought is a result of three years of below-average rainfall and limitations on export of water from the Sacramento-San Joaquin River Delta. In the Proclamation, the Governor requested that urban water users reduce water use by 20 percent. Moreover he directed the Department of

Water Resources to cooperate with local water agencies to implement aggressive water conservation efforts, and to facilitate water transfers in response to emergency conditions which may arise.

Population and Labor Force

The state's July 1, 2009 population of about 38.5 million represented over 12 percent of the total United States population. California is by far the most populous state in the nation, more than sixty percent larger than the second-ranked state according to the 2000 U.S. Census. California has grown about twice as rapidly as the national population during the last half of the 20th century, averaging about 27 percent growth for each decade between 1950 and 2000. Although California's growth has slowed since the 1980s, it is still expected to be in the range of 1 to 1.3 percent annually through the next ten years. Population growth is expected to be about seventy percent due to natural increase (excess of births over deaths) and thirty percent due to net migration into the state.

Population growth in the next five years is expected to be largest in the 65-84 years of age category. The segment of the population under age 24 will have lower than statewide average growth, reflecting lower births in the state during the 1990s. The working age population will grow at about the same rate as the overall population.

California's population is perhaps the most diverse in the nation. At the time of the 2000 Census, no single ethnic group constituted a majority of the population. It is estimated that within 10 years, Latinos will become the largest ethnic group in the state.

California's population is concentrated in metropolitan areas. According to the findings of the 2000 census, 97 percent of the population of California resided in the 25 Metropolitan Statistical Areas in the state. As of July 1, 2009, the five-county Los Angeles area accounted for 41 percent of the state's population, with over 18.5 million residents, and the nine-county San Francisco Bay Area represented nearly 20 percent, with a population of over 7.0 million.

The following table shows California's population data for 2000 through 2009.

TABLE 22
Population 2000-2009

Year	California Population^(a)	Increase Over Preceding Year (%)	United States Population^(a)	Increase Over Preceding Year (%)	California as (%) of United States
2000	34,095,000	2.0%	282,171,957	1.1%	12.1%
2001	34,767,000	2.0	285,081,556	1.0	12.2
2002	35,361,000	1.7	287,803,914	1.0	12.3
2003	35,944,000	1.6	290,326,418	0.9	12.4
2004	36,454,000	1.4	293,045,739	0.9	12.4
2005	36,899,000	1.2	295,753,151	0.9	12.5
2006	37,275,000	1.0	298,593,212	1.0	12.5
2007	37,674,000	1.1	301,579,895	1.0	12.5
2008	38,134,000	1.2	304,374,846	0.9	12.5
2009	38,488,000	0.9	307,006,550	0.9	12.5

^(a) Population as of July 1.

Source: U. S. figures from U.S. Department of Commerce, Bureau of the Census; California figures from State of California, Department of Finance.

The following table presents civilian labor force data for the resident population, age 16 and over, for the years 2000 to 2009.

TABLE 23
Labor Force 2000-2009
(Thousands)

Year	Labor Force	Employment	Unemployment Rate (%)	
			California	United States
2000	16,858	16,024	4.9%	4.0%
2001	17,152	16,220	5.4	4.7
2002	17,344	16,181	6.7	5.8
2003	17,391	16,200	6.8	6.0
2004	17,444	16,355	6.2	5.5
2005	17,629	16,672	5.4	5.1
2006	17,821	16,948	4.9	4.6
2007	18,078	17,109	5.4	4.6
2008	18,392	17,060	7.2	5.8
2009	18,250	16,164	11.4	9.3

Source: State of California, Employment Development Department.

Employment, Income, Construction and Export Growth

The following table shows California's non-agricultural employment distribution and growth for 1999 and 2009.

TABLE 24
Payroll Employment By Major Sector
1999 and 2009
(Thousands)

Industry Sector	Employment		Distribution of Employment %	
	1999	2009	1999	2009
Trade, Transportation and Utilities	2,650.6	2,636.5	18.9%	18.7%
Government				
Federal Government	270.1	251.4	1.9	1.8
State and Local Government	1,969.3	2,246.0	14.1	16.0
Professional and Business Services	2,096.8	2,051.6	15.0	14.6
Educational and Health Services	1,370.9	1,740.2	9.8	12.4
Manufacturing				
Nondurable goods	647.0	482.7	4.6	3.4
High Technology	506.5	349.3	3.6	2.5
Other Durable Goods	673.2	448.9	4.8	3.2
Leisure and Hospitality	1,299.4	1,499.0	9.3	10.6
Financial Activities	804.6	797.1	5.8	5.7
Construction	684.9	620.1	4.9	4.4
Other Services	474.0	484.3	3.4	3.4
Information	518.3	446.8	3.7	3.2
Mining and Logging	26.3	25.7	0.2	0.2
TOTAL	13,991.8	14,079.3	100%	100%

Source: State of California, Employment Development Department.

The following tables show California's total and per capita income patterns for selected years.

TABLE 25
Total Personal Income in California 1999-2008^(a)
(Dollars in Millions)

Year	Total Personal Income	% Change^(b)	California % of U.S.
1999	\$1,027,715	6.7%	13.0%
2000	1,135,342	10.5	13.3
2001	1,168,733	2.9	13.2
2002	1,187,360	1.6	13.1
2003	1,232,991	3.8	13.2
2004	1,312,244	6.4	13.2
2005	1,387,682	5.7	13.2
2006	1,495,560	7.8	13.3
2007	1,572,271	5.1	13.2
2008	1,604,113	2.0	13.1

^(a) Revised estimates as of October 16, 2009.

^(b) Change from Prior Year.

Note: Omits income for government employees overseas.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

TABLE 26
Per Capita Personal Income
1999-2008^(a)

Year	California	% Change^(b)	United States	% Change^(b)	California % of U.S.
1999	\$30,679	5.1%	\$28,333	3.9%	108.3%
2000	33,394	8.8	30,318	7.0	110.1
2001	33,869	1.4	31,149	2.7	108.7
2002	34,006	0.4	31,470	1.0	108.1
2003	34,922	2.7	32,284	2.6	108.2
2004	36,830	5.5	33,899	5.0	108.6
2005	38,670	5.0	35,447	4.6	109.1
2006	41,404	7.1	37,728	6.4	109.7
2007	43,221	4.4	39,430	4.5	109.6
2008	43,641	1.0	40,208	2.0	108.5

^(a) Revised estimates as of October 16, 2009.

^(b) Change from prior year.

Note: Omits income for government employees overseas.

Source: U.S. Department of Commerce, Bureau of Economic Analysis.

The following tables show California's residential and non-residential construction.

TABLE 27
Residential Construction Authorized by Permits
2000-2009
(Dollars in Millions)

Year	Units			Valuation^(a)
	Total	Single	Multiple	
2000	148,540	105,595	42,945	\$28,142
2001	148,757	106,902	41,855	28,804
2002	167,761	123,865	43,896	33,305
2003	195,682	138,762	56,920	38,968
2004	212,960	151,417	61,543	44,777
2005	208,972	155,322	53,650	47,138
2006	164,280	108,021	56,259	38,108
2007	113,034	68,409	44,625	28,621
2008	64,962	33,050	31,912	18,072
2009	36,327	25,343	10,984	12,015

^(a) In millions of dollars. Valuation includes additions and alterations.

Source: Construction Industry Research Board.

TABLE 28
Nonresidential Construction 2000-2009
(Dollars in Thousands)

Year	Commercial	Industrial	Other	Additions and Alterations	Total
2000	6,962,031	2,206,169	2,204,754	7,252,004	18,624,958
2001	6,195,368	1,552,047	2,584,321	6,421,551	16,753,287
2002	5,195,348	1,227,754	2,712,681	5,393,329	14,529,112
2003	4,039,561	1,320,222	2,954,039	5,601,117	13,914,939
2004	5,105,541	1,456,283	3,100,982	6,026,567	15,689,373
2005	5,853,351	1,693,373	3,818,100	6,900,709	18,265,533
2006	7,733,068	1,760,888	3,873,055	7,741,610	21,108,621
2007	8,812,083	1,450,875	3,496,471	8,782,424	22,541,853
2008	6,513,610	938,081	2,983,640	8,776,285	19,211,616
2009	1,919,163	359,868	1,998,173	6,599,336	10,876,540

Source: Construction Industry Research Board.

The following table shows changes in California's exports for the period from 2000 through 2009.

TABLE 29
Exports Through California Ports 2000-2009
(Dollars in Millions)

Year	Exports^(a)	% Change^(b)
2000	148,554.6	21.7
2001	127,255.3	(14.3)
2002	111,340.1	(12.5)
2003	113,550.7	2.0
2004	123,039.2	8.4
2005	129,988.9	5.6
2006	147,823.8	13.7
2007	159,549.5	7.9
2008	170,594.2	6.9
2009	137,215.5	(19.6)

(a) "Free along ship" value basis.

(b) Change from prior year.

Source: U.S. Department of Commerce, Bureau of the Census.

LITIGATION

The state is a party to numerous legal proceedings. The following are the most significant pending proceedings, as reported by the Office of the Attorney General. See "LITIGATION" in the main body of the Official Statement.

Budget-Related Litigation

Action Challenging School Financing

In *Robles-Wong, et al. v. State of California* (Alameda County Superior Court, Case No. RG-10-515768), plaintiffs challenge the state's "education finance system" as unconstitutional. Plaintiffs, consisting of 62 minor school children, various school districts, the California Association of School Administrators and the California School Boards Association, allege the state has not adequately fulfilled its constitutional obligation to support its public schools, and seek an order enjoining the state from continuing to operate and rely on the current financing system and to develop a new education system that meets constitutional standards as declared by the court. It is currently unknown what the fiscal impact of this matter might be upon the General Fund.

Actions Challenging Governor's Line-Item Vetoes

Two cases challenge the \$489 million in line-item vetoes the Governor made to the Amended 2009 Budget Act: *Steinberg v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case No. CPF-09-509721), and *St. John's Well Child and Family Center, et al. v. Schwarzenegger, et al.* (Court of Appeal, First Appellate District, Case No. A125750.) Both actions maintain that because the Legislature only reduced existing appropriations in the budget revision bill without making any new appropriations, the Governor was not entitled to use his line-item veto power. Both cases seek writ relief directing the State Controller to enforce the existing appropriations as reduced by the Legislature and to declare the line-item vetoes void. The Court of Appeal allowed the *Steinberg* petitioners to intervene in the *St. John's* action. The appellate court denied the writ and upheld the vetoes in the *St. John's* action. Petitioners and intervenors sought review of the ruling, and the California Supreme Court granted review.

on June 9, 2010 (California Supreme Court, Case No. S181760). The petition in the *Steinberg* action is still pending in the Superior Court, but the parties have asked the court to stay this matter pending resolution of the *St. John's* matter.

Action Challenging Proposed Sale of State Compensation Insurance Fund Assets

In *Poizner v. Genest, et al.* (Sacramento County Superior Court, Case No. 34-2009-80000310-CU-WM-GDS), the State Insurance Commissioner challenges the proposed sale of a portion of SCIF, a public enterprise providing workers' compensation insurance to California employers, asserting that the proposed sale would violate the California Constitution.

Action Challenging Budget Bill

In *Lord, et al. v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case No. CPF-09-509770), petitioners are a correctional officer and the employee organization designated as the exclusive bargaining representative of the officer and other correctional law employees. Petitioners allege that a state budget implementation bill enacted in July 2009, A.B.X4 12, violates the provision of the California Constitution which requires that a statute embrace one subject expressed in its title. The bill includes budget-related changes to statutes intended to reduce state expenses and increase state revenues, including deferral of payment of state employee compensation for the month of June 2010 from June 30 to July 1, authorization to sell a portion of SCIF's assets and liabilities, and elimination of a rural health care subsidy paid to the petitioner and other state employees. Petitioners seek a declaration that the bill is unconstitutional. If petitioners are successful, this case could invalidate the entire bill.

Actions Challenging Required Contribution by Redevelopment Agencies

Petitioners in *California Redevelopment Association, et al. v. Genest, et al.* (Sacramento County Superior Court, Case No. 34-2009-80000359), challenge the constitutionality of legislation that required that local redevelopment agencies remit a total of \$1.7 billion in fiscal year 2009-10 and \$350 million in fiscal year 2010-11 to county education funds. Petitioners are asking the trial court to enjoin implementation of the legislation. A second case challenging the constitutionality of this legislation and seeking to enjoin its implementation has been filed by seven counties. *County of Los Angeles, et al. v. Genest, et al.* (Sacramento County Superior Court, Case No. 34-2009-80000362). The trial court denied the petitions in both matters, and petitioners in the *California Redevelopment Association* matter appealed (Court of Appeal, Third Appellate District, Case No. C064907). The appellate court denied petitioners' request for a stay pending resolution of the appeal. Petitioners in the *County of Los Angeles* matter have filed a notice of appeal.

Actions Regarding Furlough of State Employees

In several cases, petitioners challenge the Governor's executive orders directing the furlough without pay of state employees. The first order, issued on December 19, 2008, directed furloughs for two days per month, effective February 1, 2009 through June 30, 2010. The second, issued on July 1, 2009, required a third furlough day per month, effective through June 30, 2010.

In four cases, the trial court upheld the Governor's authority to order furloughs. *Professional Engineers in California Government ("PECG"), et al. v. Schwarzenegger, et al.* (Sacramento County Superior Court, Case No. 34-2008-80000126-CU-WM-GDS); *California Attorneys, Administrative Law Judges and Hearing Officers in State Employment ("CASE") v. Schwarzenegger, et al.* (Sacramento County Superior Court, Case No. 34-2009-80000134-CU-WM-GDS); *Service Employees International Union, Local 1000 ("SEIU") v. Schwarzenegger, et al.* (Sacramento County Superior Court, Case No. 34-2009-80000135-CU-WM-GDS); and *California Correctional Peace Officers' Association ("CCPOA") v. Schwarzenegger, et al.* (Sacramento County Superior Court, Case No. 34-2009-

80000137-CU-WM-GDS). Three of the petitioners, PECG, CASE, and SEIU, appealed. (Court of Appeal, Third Appellate District, Case Nos. C061011, C061009, and C061020, respectively). On June 9, 2010, the California Supreme Court on its own motion ordered these three cases (PECG, CASE and SEIU) transferred to the Supreme Court (California Supreme Court, Case No. S183411). The Court's transfer order indicated all prior briefing would be considered by it and also requested supplemental briefing on specified issues.

Three pending cases involve the application of the furlough order to employees of SCIF. In *CASE v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case No. CPF-09-509205), the trial court ruled that the furlough order did not apply to attorneys employed by SCIF. The appellate court ruled against the state and upheld the trial court ruling (Court of Appeal, First Appellate District, Case No. A125292). This case is now before the California Supreme Court, which has set an expedited briefing schedule (California Supreme Court, Case No. S182581). In *SEIU v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case No. CPF-09-509580), plaintiff challenged the order as applied to other SCIF employees based on SCIF's governing statutes which prohibit the state from "adjusting" its staffing levels. The trial court ruled that the furlough order did not apply to the SCIF employees, and on June 11, 2010, the Court of Appeal affirmed the trial court ruling (Court of Appeal, First Appellate District, Case No. A126525). In *International Union of Operating Engineers, Locals 3, 12, 39 and 501 v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case No. CGC-09-492675), plaintiffs are challenging the order as applied to other SCIF employees in different unions based on the SCIF governing statute.

In *California Association of Psychiatric Technicians ("CAPT") v. Schwarzenegger, et al.* (Sacramento County Superior Court, Case No. 34-2009-80000148-CU-WM-GDS); and *CDF Firefighters v. Schwarzenegger, et al.* (Sacramento County Superior Court, Case No. 34-2009-00032732-CU-WM-GDS), petitioners challenge the furlough order as applied to their respective members. The trial court has dismissed the CAPT matter for failure to exhaust administrative remedies. *CASE v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case No. CPF-09-509629) challenges the July 1, 2009 executive order implementing the third furlough day.

In *CCPOA v. Schwarzenegger, et al.* (Alameda County Superior Court, Case No. RG-09-441544), petitioner alleges that the furloughs violate Government Code 19826 because its members (correctional officers) cannot take their furlough days off during the same pay period in which their salaries are reduced because of operational needs. The trial court found in favor of CCPOA and directed the state to pay CCPOA members for all hours worked. The state filed a notice of appeal and the trial court's order is stayed pending further briefing in the appellate court (Court of Appeal, First Appellate District, Case No. A127292).

In *Newton v. Schwarzenegger, et al.* (U.S. District Court, Northern District, Case No. 09-CV-05887 JCS), correctional officers allege that the furloughs violate the federal Fair Labor Standards Act.

In *California Professional Public Employees Association, et al. v. Schwarzenegger, et al.* (Sacramento County Superior Court, Case No. 34-2009-80000308), petitioners allege the state is violating Labor Code Section 212 by permitting some employees to "accrue furlough days." The trial court ruled for the state. In *California Correctional Supervisor's Organization v. California Department of Corrections and Rehabilitation, et al.* (Sacramento County Superior Court, Case No. 34-2009-00063209-CU-OE-GDS), plaintiff alleges that the furloughs violate the state Labor Code when correctional supervisors work furlough days but are not paid wages for those days during the same pay period.

Walker, et al. v. Schwarzenegger, et al. (Sacramento County Superior Court, Case No. 34-2009-80000150-CU-WM-GDS) alleges that the furlough order is invalid because it does not comply with state law requirements for promulgating regulations.

In *SEIU v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case No. CPF-09-509782), petitioners allege the furloughs violate the state Emergency Services Act and undermine the Legislature's budgetary authority.

In *CASE v. Schwarzenegger, et al.* (Alameda County Superior Court, Case No. RG-09-453982); *Union of American Physicians and Dentists ("UAPD") v. Schwarzenegger, et al.* (Alameda County Superior Court, Case No. RG-09-456684); *SEIU v. Schwarzenegger, et al.* (Alameda County Superior Court, Case No. RG-09-456750); *California Association of Professional Scientists ("CAPS"), et al. v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case No. CPF-09-509695); *International Union of Operating Engineers v. Schwarzenegger, et al.* (Los Angeles County Superior Court, Case No. BC423409); and *PECG v. Schwarzenegger, et al.* (Alameda County Superior Court, Case No. RG-10-494800), the employee organizations allege that the Governor illegally furloughed employees who are paid from Special Funds because the deficit stems from general fund deficiencies and therefore furloughing employees who are paid with Special Funds will not result in any benefit or cost savings. In the case brought by CAPS, the trial court ruled in favor the state, and CAPS appealed (Court of Appeal, First Appellate District, Case No. A128427). In the matters brought by CASE, UAPD and SEIU, the trial court ruled in favor of the plaintiffs, finding the furloughs were improper, and final judgment was entered on February 25, 2010. The judgment applies to all employees of agencies sued in the three lawsuits, and includes an award of back pay. An appeal in these cases was filed by the state (Court of Appeal, First Appellate District, Case Nos. A127775, A127776, A127777), and the judgment was stayed due to the appeal. On March 24, 2010, the trial court judge lifted the stay with respect to the furloughs and ordered that furloughs cease with respect to the specially funded departments and agencies named in these cases. The portion of the judgment with respect to back pay remains stayed pending appeal. On March 29, 2010, the state requested the appellate court stay the trial court order with respect to ending the furloughs, and after initially issuing a temporary stay in these three appeals, the appellate court has issued a stay pending the outcome of the appeals. The matter brought by PECG is pending in the trial court. An additional lawsuit challenging the Governor's authority to furlough state employees of specially funded state entities was filed on May 21, 2010. *SEIU v. Schwarzenegger* (Alameda County Superior Court, Case No. RG-10-516259).

In *Association of California State Supervisors (ACSS) v. Schwarzenegger, et al.* (Alameda County Superior Court, Case No. RG-10-501997), *International Union of Operating Engineers (IUOE) v. Schwarzenegger* (Alameda County Superior Court, Case No. RG-10-503805), *SEIU v. Schwarzenegger, et al.* (Alameda County Superior Court, Case No. RG-09-546750), and *California Correctional Supervisors Organization (CCSO) v. California Department of Corrections and Rehabilitation, et al.* (Alameda County Superior Court, Case No. RG-10-507081), plaintiffs challenge the furloughs as allegedly violating provisions of state law. *California Statewide Law Enforcement Association (CSLEA), et al. v. Schwarzenegger, et al.* (Alameda County Superior Court, Case No. RG-10-507081), filed as a class action on behalf of all current and former members of the employee organization, challenges the furlough orders as violating numerous provisions of state law.

In *Board of Administration of the California Public Employees' Retirement System v. Schwarzenegger* (San Francisco County Superior Court, Case No. CPF-09-509754), plaintiff alleges that the furloughs unlawfully interfere with its ability to carry out its constitutional obligation to its participants and beneficiaries. The trial court ruled in favor of the state.

In *California Medical Association v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case No. CPF-09-509896), plaintiff challenges the Governor's furlough orders, and asserts that the furloughs interfere with the California Medical Board's timely performance of its regulatory functions. The trial court entered judgment in the state's favor in this case, and plaintiff appealed (Court of Appeal, First Appellate District, Case No. A128172). In *Acosta v. Henning, et al.* (San Francisco County Superior Court, Case No. CPF-08-508192), plaintiffs assert that the furloughs interfere with the ability of the

California Employment Development Department and the California Unemployment Insurance Appeals Board to timely perform their functions.

In a separate action, *Schwarzenegger, et al. v. Chiang, et al.* (Sacramento County Superior Court, Case No. 34-2009-80000158-CU-WM-GDS), the Governor is seeking an order to compel the State Controller to implement the reduction in wages as a result of the reduced work time (furlough) with respect to employees of other statewide elected executive branch officers, including the Lieutenant Governor, State Controller, Secretary of State, State Treasurer, Superintendent of Public Instruction, Insurance Commissioner, and Attorney General. The trial court ruled in favor of the Governor, and the State Controller, Lieutenant Governor, Secretary of State, Attorney General, State Treasurer, Superintendent of Public Instruction and State Board of Equalization appealed (Court of Appeal, Third Appellate District, Case No. C061648).

Action Challenging Transfers from Special Fund to General Fund

In *TOMRA Pacific, Inc. et al. v. Chiang, et al.* (Alameda County Superior Court, Case No. RG-09-483580), plaintiffs challenge three transfers totaling \$415.7 million from a special fund, the California Beverage Container Recycling Fund, to the General Fund, asserting that the transfers have interfered with the operation of the recycling program for which the special fund was created, in violation of state law. In *California Chamber of Commerce et al. v. Chiang et al.* (Alameda County Superior Court, Case No. RG 09-490447), which has been consolidated with the *TOMRA* case, plaintiffs challenge these same transfers on the grounds that their inclusion in the Budget Act violates the provision of the California Constitution which requires that a statute embrace one subject. On June 15, 2010, the trial court issued a ruling denying the plaintiffs' requests for a writ of mandate in both cases. It is not known whether plaintiffs will appeal this ruling.

In *California Medical Association v. Schwarzenegger, et al.* (San Francisco County Superior Court, Case No. CPF-09-509896), discussed above, plaintiff also challenges the transfer of \$6 million from the Medical Board's special fund to the General Fund and seek its repayment. The trial court entered judgment in the favor of the state on this issue, and plaintiff filed a notice of appeal.

Tax Cases

Six actions have been filed contending that the Legislature's modification of Revenue and Taxation Code Section 25128, which implemented the double-weighting of the sales factor in California's apportionment of income formula for the taxation of multistate business entities, is invalid and/or unconstitutional. *Kimberly-Clark Worldwide, Inc., et. al. v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-495916); *Gillette Company and Subsidiaries v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-495911); *Proctor & Gamble Manufacturing Company & Affiliates v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-495912); *Sigma-Aldrich, Inc. and Affiliates v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-496437); *RB Holdings (USA), Inc. v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-496438); and *Jones Apparel Group v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-10-499083), now consolidated in one matter, collectively referred to as *Gillette Company v. Franchise Tax Board*. Plaintiffs contend that the single-weighted sales factor specified in Section 25128 prior to amendment was contained within the Multistate Tax Compact and therefore cannot be modified without repealing the legislation that enacted the Compact. An adverse ruling in these cases would affect multiple taxpayers and create potential exposure to refund claims in excess of \$750 million.

A pending case challenges the fee imposed by the state tax code upon LLCs registered in California, alleging that it discriminates against interstate commerce and violates the U.S. and California Constitutions, it is an improper exercise of the state's police powers, and it has been misapplied by the

Franchise Tax Board. *Bakersfield Mall LLC v. Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-07-462728). *Bakersfield Mall* was filed as a purported class action on behalf of all LLCs operating solely in California. Plaintiff has filed an amended complaint to allege that not all of its income is derived solely from sources in California, which would call into question the class plaintiff purports to represent. A second lawsuit that is virtually identical to *Bakersfield Mall* has been filed, and also seeks to proceed as a class action. *CA-Centerside II, LLC v. Franchise Tax Board* (Fresno County Superior Court, Case No. 10 CECG00434). If either case proceeds as a class action, the claimed refunds could be significant. See “STATE FINANCES – Sources of Tax Revenue - Corporation Tax.”

Plaintiff in *River Garden Retirement Home v. California Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-07-467783) challenges the constitutionality of the penalty assessed under the state’s tax amnesty program. Under the amnesty program, for taxable years beginning before January 1, 2003, taxpayers that had not paid or had underpaid an eligible tax could agree to pay the tax and waive their rights to claim refunds thereof. In exchange, certain penalties and fees associated with the unpaid taxes would be waived and no criminal actions would be brought for the tax years for which amnesty was allowed. The program also imposed a new penalty equal to 50 percent of accrued interest as of March 31, 2005, on any unpaid tax liabilities ultimately determined to be due for tax years 2002 and earlier for which amnesty could have been requested. The trial court granted summary judgment for the state. Plaintiff appealed (Court of Appeal, First Appellate District, Case No. A123316). The potential fiscal impact of the case is dependent on further court rulings, but is estimated to be in excess of \$300 million.

Nortel Networks Inc. v. State Board of Equalization (Los Angeles County Superior Court, Case No. BC 341568) and *Lucent Technologies, Inc. v. State Board of Equalization* (Los Angeles County Superior Court, Case No. BC 402036), tax refund cases, involve the interpretation of certain statutory sales and use tax-exemptions for “custom-written” computer software and licenses to use computer software. In *Nortel*, the trial court ruled in favor of plaintiff and the State Board of Equalization appealed (Court of Appeal, Second Appellate District, Case No. B213415). The ruling, if applied to other similarly situated taxpayers, could have a significant negative impact, in the range of approximately \$500 million annually, on tax revenues.

In *River Garden Retirement Home v. California Franchise Tax Board* (San Francisco County Superior Court, Case No. CGC-07-467783), plaintiff is challenging the denial of a deduction for dividends under Revenue and Taxation Code Section 24402. After Section 24402 was held to be unconstitutional because it allowed a dividend deduction only to the extent the dividends were paid from income previously taxed by California, the Franchise Tax Board allowed a deduction for all dividends for years in which the normal 4-year statute of limitations prevented additional assessments and denied the deduction for all dividends in years in which the 4-year statute was still open. The trial court sustained the demurrer of the Franchise Tax Board on this issue and the plaintiff appealed; plaintiff also challenges the tax amnesty penalty, as described above. An adverse ruling in this matter, applied in the context of other statutes, could have a significant revenue impact.

In *Computer Service Tax Cases (Dell, Inc. v. State Board of Equalization)*, the Court of Appeal ruled that the State Board of Equalization improperly collected sales and use tax on optional service contracts that Dell sold with computers (Judicial Council Coordination Proceeding No. 4442, San Francisco County Superior Court, Case No. CGC-03-419192 and Court of Appeal, First Appellate District, Case No. A118657). The decision will lead to a judgment requiring the Board to refund the tax with interest. The amount of the refund has not been determined but, with interest, may exceed \$250 million.

Petitioners in *California Taxpayers Association v. Franchise Tax Board* (Sacramento County Superior Court, Case No. 34-2009-800000168-CU-WM-GDS) challenge Revenue and Taxation Code

Section 19138, which imposes a penalty for large understatement of corporate tax, alleging it violates the state and federal constitutions, and was not properly enacted. The trial court ruled in favor of the Franchise Tax Board. Petitioner appealed (Court of Appeal, Third Appellate District, Case No. C062791). An adverse ruling enjoining collection of the tax could have a significant impact on tax revenue. See “STATE FINANCES – Sources of Tax Revenue – Corporation Tax.”

Environmental Matters

In a federal Environmental Protection Agency (“U.S. EPA”) administrative abatement action titled *In the Matter of: Leviathan Mine, Alpine County, California, Regional Water Quality Control Board, Lahontan Region, State of California* (U.S. EPA Region IX CERCLA Docket No. 00-16(a)), the state, as owner of the Leviathan Mine, is a party through the Lahontan Regional Water Quality Control Board. The Atlantic Richfield Company (“ARCO”) is a party as the successor in interest to the mining company that caused certain pollution of the mine site. The Leviathan Mine site is listed on the U.S. EPA “Superfund” List, and both remediation costs and costs for Natural Resource Damages may be imposed on the state. The alleged bases for the state’s liability are the state’s ownership of the mine site and the terms of a 1983 settlement agreement between the state and ARCO. The Lahontan Regional Water Quality Control Board has undertaken certain remedial action at the mine site, but the U.S. EPA’s decision on the interim and final remedies is pending. ARCO has sued the state, the State Water Resources Control Board, and the Lahontan Regional Water Quality Control Board, seeking to recover past and future costs, based on the settlement agreement, the state’s ownership of the property, and the state’s allegedly negligent past clean up efforts. *Atlantic Richfield Co. v. State of California* (Los Angeles County Superior Court, Case No. BC 380474). It is possible these matters if determined adversely to the state could result in potential liability in the hundreds of millions of dollars.

In *Pacific Lumber Company, et al. v. State of California, et al.* (Sacramento County Superior Court, Case No. 34-2009-00042016), plaintiffs are seeking injunctive relief and damages against the state for an alleged breach of the Headwaters Agreement. The Headwaters Agreement was reached in 1996, and involved the sale of certain timberlands by plaintiffs to federal and state agencies. Plaintiffs allege that the state’s environmental regulation of plaintiffs’ remaining timberlands since the Headwaters Agreement constitutes a breach of the Agreement. The state denies plaintiffs’ allegations. The current plaintiffs are successors in interest to original plaintiffs, who are debtors in a bankruptcy proceeding. In that proceeding, the debtors have claimed that the value of the litigation ranges from \$626 million to \$639 million in the event they could establish liability. It is currently unknown what the fiscal impact of this matter might be upon the General Fund.

In *City of Colton v. American Professional Events, Inc. et al.* (Los Angeles County Superior Court, Case No. BC 376008), two defendants in an action involving liability for contaminated groundwater have filed cross complaints seeking indemnification from the state and the Regional Water Quality Control Board in an amount of up to \$300 million.

Escheated Property Claims

In two cases, plaintiffs claim that the state has an obligation to pay interest on private property that has escheated to the state, and that failure to do so constitutes an unconstitutional taking of private property: *Suever v. Connell* (U.S. District Court, Northern District, Case No. C03-00156 RS); and *Taylor v. Chiang* (U.S. District Court, Eastern District, Case No. S-01-2407 WBS GGH). Both *Suever* and *Taylor* are styled as class actions but to date no class has been certified. The *Suever* and *Taylor* plaintiffs argue that the state’s failure to pay interest on claims paid violated their constitutional rights. In *Suever*, the district court concluded that the state is obligated to pay interest to persons who reclaim property that has escheated to the state, but its ruling did not specify the rate at which interest must be paid. The district court certified this issue for appeal. Plaintiffs in *Suever* and *Taylor* also assert that for the

escheated property that has been disposed of by the state, plaintiffs are entitled to recover, in addition to the proceeds of such sale, any difference between the sale price and the property's highest market value during the time the state held it; the state asserts that such claims for damages are barred by the Eleventh Amendment. The district court granted the state's motion for summary judgment on this claim in *Suever*, and plaintiffs appealed. The Ninth Circuit ruled against plaintiffs on the two consolidated *Suever* appeals, holding that the state is not required to pay interest and that the Eleventh Amendment bars plaintiffs from suing in federal court for anything other than the return of their property or the proceeds of its sale. (U.S. Court of Appeals, Ninth Circuit, Case No. 08-015884). The Ninth Circuit denied plaintiffs' request for rehearing and plaintiffs declined to seek review in the U.S. Supreme Court. The state has filed a motion for summary judgment on all remaining claims in *Suever*, which is scheduled to be heard in July 2010.

Actions Seeking Damages for Alleged Violations of Privacy Rights

In *Gail Marie Harrington-Wisely, et al. v. State of California, et al.* (Los Angeles County Superior Court, Case No. BC 227373), plaintiffs seek damages, asserting that the use by CDCR of a body-imaging machine to search visitors entering state prisons for contraband violated the rights of the visitors. This matter was certified as a class action. The trial court granted judgment in favor of the state. Plaintiffs' appeal has been dismissed (Court of Appeal, Second Appellate District, Case No. B190431) and the trial court denied plaintiffs' motion for attorneys' fees. Plaintiffs may seek further review of the trial court's rulings. If plaintiffs were successful in obtaining an award of damages for every use of the body-imaging machine, damages could be as high as \$3 billion.

Plaintiff in *Gilbert P. Hyatt v. Franchise Tax Board* (State of Nevada, Clark County District Court, Case No. A382999) was subject to an audit by the Franchise Tax Board involving a claimed change of residence from California to Nevada. Plaintiff alleges a number of separate torts involving privacy rights and interference with his business relationships arising from the audit. The trial court ruled that plaintiff had not established a causal relation between the audit and the loss of his licensing business with Japanese companies; the Nevada Supreme Court denied review of this ruling. The economic damages claim exceeded \$500 million. On the remaining claims, the jury awarded damages of approximately \$387 million, including punitive damages, and over \$1 million in attorneys' fees. The total judgment with interest is approximately \$490 million. The state appealed and the Nevada Supreme Court has granted a stay of execution on the judgment pending appeal. The state will vigorously pursue its appeal of this unprecedented award.

Actions Regarding Medi-Cal Reimbursements and Fees

In *Orinda Convalescent Hospital Inc., et al. v. Department of Health Services et al.* (Sacramento County Superior Court, Case No. 06CS01592), plaintiffs challenge a quality assurance fee charged to skilled nursing facilities and a Medi-Cal reimbursement methodology applicable to such facilities that was enacted in 2004, alleging violations of the federal and state constitutions and state law. Plaintiffs seek a refund of fees paid and to enjoin future collection of the fee. If an injunction against collection of the fee is issued, it could negatively affect the state's receipt of federal funds. At this time it is unknown what fiscal impact this matter would have upon the state's General Fund.

Other pending cases challenge state legislation requiring reductions in Medi-Cal reimbursements to providers. In *Independent Living Center of Southern California, et al. v. Shewry, et al.* (U.S. District Court, Central District, Case No. CV 08-3315 CAS (MANx)), health care advocates, Medi-Cal providers and Medi-Cal recipients challenge various 10 percent rate reductions, the 10 percent "actuarial equivalent" managed care rate reductions, the hold on payments to providers for one month prior to January 2009, and delays in the annual cost of living adjustments in the state-funded SSI/SSP. Plaintiffs seek injunctive relief to prevent implementation of these measures. The district court granted in part a preliminary injunction, requiring the state, as of August 18, 2008, to pay the rates in effect prior to the 10

percent reduction. The district court thereafter issued a second preliminary injunction, restoring the rates in effect prior to the reduction, as of November 2008, for two additional categories of services. The state and plaintiffs appealed and the Ninth Circuit affirmed the preliminary injunctions. (U.S. Court of Appeals, Ninth Circuit, Case No. 08-56422.) The Ninth Circuit also found that the district court erred in making the injunction effective as of August 18, 2008, and that the injunction should apply to services rendered on or after July 1, 2008. The Ninth Circuit denied both petitions for rehearing filed by the state. The state filed a petition for certiorari in the U.S. Supreme Court, and the Court invited the Solicitor General to file a brief expressing its views on the petition. The district court amended the injunction to apply retroactively. On June 17, 2010, the district court stayed further proceedings pending resolution of the petition for certiorari. A final decision adverse to the state in this matter could result in additional costs to the General Fund of \$70 million.

In *California Medical Association, et al. v. Shewry, et al.* (Los Angeles County Superior Court, Case No. BC 390126), professional associations representing Medi-Cal providers seek to enjoin implementation of the 10 percent Medi-Cal rate reductions planned to go into effect on July 1, 2008, alleging that the legislation violates federal Medicaid requirements, state laws and regulations, and the California Constitution. The trial court denied plaintiffs' motion for a preliminary injunction. Plaintiffs filed an appeal, which was dismissed at their request. (Court of Appeal, Second Appellate District, Case No. B210440.) Plaintiffs have indicated that they will file an amended petition seeking the retrospective relief the Ninth Circuit awarded in the *Independent Living* case, above, after final disposition of that case. A final decision adverse to the state in this matter could result in costs to the General Fund of \$508.2 million.

In *California Pharmacists Association, et al. v. David Maxwell-Jolly, et al.*, (U.S. District Court, Central District, Case No. CV09-08200), Medi-Cal pharmacy providers filed a suit challenging reimbursement rates, including the Department of Health Care Services' use of reduced published average wholesale price data to establish reimbursement rates, and challenging the Legislature's amendment of Welfare and Institutions Code section 14105.45 and enactment of Welfare and Institutions Code section 14105.455. Plaintiffs seek injunctive relief based on alleged violations of federal law. The district court granted a request for preliminary judgment in part, with respect to sections 14104.45 and 14105.455, and denied it in part, with respect to the Department of Health Care Services' use of reduced published average wholesale price data to establish reimbursement rates. Plaintiffs filed a motion seeking to modify the district court ruling, and both parties filed notices of appeal to the Ninth Circuit Court of Appeals. At this time it is unknown what fiscal impact this case would have on the state's General Fund.

In *Centinela Freeman Emergency Medical Associates, et al. v. David Maxwell-Jolly, et al.* (Los Angeles County Superior Court, Case No. BC 406372), filed as a class action on behalf of emergency room physicians and emergency department groups, plaintiffs claim that Medi-Cal rates for emergency room physicians are below the cost of providing care. Plaintiffs seek damages, injunctive relief, and a writ of mandate based on alleged violations of state law and the federal and state Constitutions. At this time it is unknown what fiscal impact this case would have on the state's General Fund.

Action to Increase Amount of State Aid for Dependent Children

In a statewide class action, *Katie A., et al. v. Bonta, et al.* (U.S. District Court, Central District, Case No. CV 02-05662 AHM (SHx)), plaintiffs seek to expand Medicaid-covered services for mentally disordered children in foster care. The district court issued a preliminary injunction ordering the state defendants to provide additional services to class members. Further, the court ordered the state defendants and plaintiffs to meet and confer both to develop a plan to implement the preliminary injunction and to come to consensus on whether the court should appoint a special master. On appeal (U.S. Court of Appeals, Ninth Circuit, Case No. 06-55559), the Ninth Circuit reversed the decision of the district court and remanded the matter for further proceedings. Plaintiffs filed another motion for

preliminary injunction in the district court. The district court vacated the motion without prejudice and appointed a special master to assist the parties in resolving differences. At this time, it is unknown what financial impact this unprecedented litigation would have on the state's General Fund.

Local Government Mandate Claims and Actions

In litigation filed in November 2007, *California School Boards Association, et al. v. State of California, et al.* (San Diego County Superior Court, Case No. 37-2007-00082249-CU-WM-CTL), plaintiffs, including the San Diego County Office of Education and four school districts, allege the state has failed to appropriate approximately \$900 million for new state-required programs or services in violation of the California Constitution. Plaintiffs sought declaratory and injunctive relief, including an order compelling reimbursement. The trial court ruled that the legislature had improperly failed to fund state education mandates, but refused to grant writ relief for the \$900 million sought by the plaintiffs. The state has appealed the ruling regarding the failure to fund mandates and plaintiffs filed a cross-appeal regarding the denial of an order to pay \$900 million allegedly owed (Court of Appeal, Fourth Appellate District, Case No. D055659). The trial court judgment has been stayed pending resolution of the appeal. At this time it is unknown what fiscal impact this matter would have upon the state's General Fund.

In *Department of Finance v. Commission on State Mandates, et al.* (Sacramento County Superior Court, Case No. 03CS01432), the Department of Finance is seeking to overturn a determination of the Commission on State Mandates that a state law requiring the development of a behavioral intervention plan for certain children receiving special education services exceeds the federal requirements for individualized education plans and therefore is an unfunded state mandate. The parties have reached a settlement agreement, subject to legislative approval, under which the state would pay school districts \$510 million in retroactive reimbursements over six years starting in fiscal year 2011-12, and will permanently increase the special education funding formula by \$65 million annually, beginning in fiscal year 2009-10. If the Legislature does not approve the settlement, trial in this matter is set for December 2010.

In *Department of Finance v. Commission on State Mandates* (Sacramento County Superior Court, Case No. 34-2010-80000529), the state is appealing a determination by the Commission on State Mandates relating to whether the requirement for completion of a second science course for graduation from high school constitutes a reimbursable state-mandated program. Following court action on consolidated cases involving challenges to the State Controller's Office reduction of claims (*San Diego Unified School District, et al. v. Commission on State Mandates, et al.* (Sacramento County Superior Court, Case No. 03CS01401) and *Woodland Joint Unified School District v. Commission on State Mandates, et al.* (Sacramento County Superior Court, Case No. 05CS01401)), the Commission adopted revised parameters and guidelines which included a reasonable reimbursement methodology for claiming increased teacher costs. (CSM 41 81A, 04-PGA-30, 05-PGA-05, and 06-PGA-05). Historically, education-related state mandate claims are funded from moneys provided to meet the Proposition 98 Guarantee. The Commission's adoption of the revised parameters and guidelines could result in a reimbursement requirement that exceeds the funding available through the Proposition 98 Guarantee in any one fiscal year.

Actions Relating to Certain Tribal Gaming Compacts

In June 2004, the state entered into amendments to tribal gaming compacts (the "Amended Compacts") between the state and five Indian Tribes (the "Five Tribes"). Those Amended Compacts are being challenged in two pending cases, as described below. A decision unfavorable to the state in the cases described below (or in any future litigation relating to the Amended Compacts) could eliminate future receipts of gaming revenues anticipated to result from the Amended Compacts, and could impair

the state's ability to sell a portion of the revenue stream anticipated to be generated by these Amended Compacts.

In *Rincon Band of Luiseno Mission Indians of the Rincon Reservation v. Schwarzenegger, et al.* (U.S. District Court, Southern District, Case No. 04 CV 1151 W (WMc)) plaintiff (the "Rincon Band" or "Rincon") sought an injunction against implementation of the Amended Compacts on grounds that their execution and ratification by the state constituted an unconstitutional impairment of the state's compact with the Rincon Band. The Rincon Band asserts that its compact contains an implied promise that the state would not execute compacts or compact amendments with other tribes that would have an adverse impact on the Rincon Band's market share by allowing a major expansion in the number of permissible gaming devices in California. The complaint also asserts that the state breached Rincon's compact, principally by incorrectly calculating the total number of gaming device licenses the state is authorized to issue tribes with compacts identical to Rincon's compact and by failing to negotiate a compact amendment with the Rincon Band in good faith. The district court dismissed the impairment of contract claims, the claim regarding the total number of gaming device licenses, and a claim for damages sought for a separate alleged breach of compact but did not dismiss Rincon's other breach of compact claims, including a claim that the state failed to negotiate a compact amendment with the Rincon Band in good faith. The district court entered a separate judgment with respect to the dismissed claims, and Rincon appealed (U.S. Court of Appeals, Ninth Circuit, Case No. 06-055259). On appeal, the Rincon Band did not challenge the validity of the Amended Compacts. The Ninth Circuit reversed the dismissal of the claim involving the authorized number of gaming device licenses and affirmed the dismissal of the Rincon's claim for damages. The U.S. Supreme Court denied the state's petition, seeking review of the Ninth Circuit's decision to allow the challenge to the number of authorized gaming device licenses to proceed in the absence of other tribal parties. The district court granted summary judgment for Rincon on its claim that the state failed to negotiate a compact amendment in good faith and denied summary judgment on other Rincon claims regarding negotiation of a compact amendment and disposition of licenses issued to tribes with amended compacts, and both parties appealed. The Ninth Circuit denied the state's request to ask the California Supreme Court to interpret a state constitutional provision regarding the state's authority to negotiate gaming compacts with tribes, and affirmed the district court's judgment finding that the state had failed to negotiate a compact amendment in good faith. The district court granted Rincon's partial motion for summary judgment on its remaining claim regarding the authorized number of gaming device licenses.

In *San Pasqual Band of Mission Indians v. State of California, et al.* (U.S. District Court, Southern District, Case No. 06 CV 0988 LAB AJB), plaintiff seeks a declaration that more aggregate slot machine licenses are available for issuance to all tribes that signed compacts with the state (the 1999 Compact) than the number of such licenses determined by the state in 2002. Should relief be granted and more licenses become available, the Five Tribes' obligations to continue to fund state transportation bonds under the Amended Compacts would be rendered uncertain because the Amended Compacts contemplated that the license pool created by the 1999 Compact would remain fixed at the number determined by the state. An expanded license pool would thus present questions about the Five Tribes' monetary obligations that would presumably be required to be addressed by amendment of the Amended Compacts. The district court dismissed the complaint, and plaintiff appealed (U.S. Court of Appeals, Ninth Circuit, Case No. 07-55536). The Ninth Circuit reversed the district court order and remanded the matter to the district court. The district court granted plaintiff's motion for summary judgment regarding the number of licenses, and the state appealed (U.S. Court of Appeals, Ninth Circuit, Case No. 10-55858).

In a separate action, *Twenty-Nine Palms Band of Mission Indians v. Stanislaus, et al.* (U.S. District Court, Central District, Case No. EDCV 08-1753 VAP), plaintiff tribe seeks an injunction and a declaration that federal law exempts from state taxation (1) monetary distributions made to tribe members and derived from its casino gambling operation profits, and (2) income earned by tribe members by means of employment at the tribe casino. The district court dismissed the complaint without leave to

amend and plaintiff appealed (U.S. Court of Appeals, Ninth Circuit, Case No. 10-55965). It is currently unknown what the fiscal impact of this matter might be upon the General Fund, should the plaintiff obtain a favorable ruling that may be applicable to other similarly situated taxpayers.

Prison Healthcare Reform and Reduction of Prison Population

The adult prison health care delivery system includes medical health care, mental health care and dental health care. The annual budget for this system, which is operated by the CDCR and affects approximately 33 prisons throughout the state, exceeds \$1.8 billion. There are three significant cases pending in federal district courts challenging the constitutionality of prison health care. *Plata v. Schwarzenegger* (U.S. District Court, Northern District, Case No. C 01-1351 TEH) is a class action regarding the adequacy of medical health care; *Coleman v. Schwarzenegger* (U.S. District Court, Eastern District, Case No. CIV S-90-0520 LKK JFM P) is a class action regarding mental health care; and *Perez v. Tilton* (U.S. District Court, Northern District, Case No. C 05-05241 JSW) is a class action regarding dental health care. A fourth case, *Armstrong v. Schwarzenegger* (U.S. District Court, Northern District, Case No. C 94-02307 CW) is a class action on behalf of inmates with disabilities alleging violations of the Americans with Disabilities Act and Section 504 of the Rehabilitation Act. In *Plata* the district court appointed a Receiver, who took office in April 2006, to run and operate the medical health care portion of the health care delivery system. The *Plata* Receiver and the Special Master appointed by the *Coleman* court, joined by the court representatives appointed by the *Perez* and *Armstrong* courts, meet routinely to coordinate efforts in these cases. To date, ongoing costs of remedial activities have been incorporated into the state's budget process. However, at this time, it is unknown what financial impact this litigation would have on the state's General Fund, particularly in light of the unprecedented step of appointing a Receiver of medical health care. The Receiver filed a motion in the *Plata* case, asking the court to hold the Governor and State Controller in contempt of court for failing to fund prison healthcare capital projects the Receiver wishes to construct and to order the state to pay \$8 billion to fund such projects. On October 27, 2008, the district court ordered the state to transfer \$250 million to the Receiver. The court indicated it would proceed later with the additional amounts requested by the Receiver. The state appealed that order and the Ninth Circuit Court of Appeals dismissed the state's appeal for lack of jurisdiction, stating that the order to pay \$250 million was an interim order in the contempt proceedings. The district court also denied the state's motion to terminate the Receiver, and the state appealed that order. See "STATE FINANCES – Department of Corrections and Rehabilitation – Prison Construction Program."

In *Plata* and *Coleman*, discussed above, a three-judge panel was convened to consider plaintiffs' motion for a prisoner-release order. The motions alleged that prison overcrowding was the primary cause of unconstitutional medical and mental health care. After a trial, the panel ordered the state to prepare a plan for the release of approximately 46,000 prisoners over two years. The state filed a prisoner-release plan with the three-judge panel and filed an appeal in the U.S. Supreme Court. On June 14, 2010, the U.S. Supreme Court granted the state's request for review of the prisoner release order. The matter will be considered in the Court's 2010-11 term.

Actions Seeking Americans with Disabilities Act Compliance for Pedestrian Facilities

The state highway system includes approximately 2,500 miles of conventional (non-freeway) highways that include sidewalks and other pedestrian facilities. The Department of Transportation's ("Caltrans") current design standards include Americans with Disabilities Act ("ADA")-compliant standards for new construction, but a significant portion of previously-constructed intersections at existing locations either remain to have curb ramps installed, or have previously-installed ADA curb ramps that need modification to meet evolving ADA standards. In addition, appellate decisions have extended the applicability of ADA requirements to sidewalks. *Californians for Disability Rights, Inc., et al. v. California Department of Transportation, et al.* (U.S. District Court, Northern District, Case No. C

06-5125 SBA and Alameda County Superior Court, Case No. RG 08376549) are class actions on behalf of mobility-impaired and visually-impaired Californians alleging violations of the ADA and Section 504 of the Rehabilitation Act regarding these pedestrian facilities. The lawsuits attempt to accelerate and expand the Department's ongoing ADA efforts on existing facilities. Costs for both new construction and remedial work associated with such efforts come from the State Highway Account. Since 1995, the Department's ADA compliance costs have exceeded \$100 million. The parties have reached a settlement agreement in the federal action, pursuant to which the state would expend \$1.1 billion over thirty years to be paid from the State Highway Operations account. After class members were provided notice and an opportunity to comment or object to the proposed settlement, the federal court approved the settlement. The state court action had been tentatively dismissed contingent upon approval of the settlement in the federal action.

Construction-Related Actions Against the Department of Transportation

Willemsen, et al. v. State of California, et al. (San Bernardino County Superior Court, Case No. RCV 071843) is an inverse condemnation action, nuisance and negligence action arising out of construction, maintenance and operation of a state highway. It was originally filed by the owners of 595 homes who sought damages in the amount of \$600 million, alleging excessive dust and noise as well as structural damage to some of the homes. Approximately half of the plaintiffs are no longer pursuing these claims.

A pending litigation matter, *Otay River Constructors v. South Bay Expressway, et al.* (San Diego County Superior Court Consolidated Action, Case No. GIC 869386), relates to an agreement between Caltrans and South Bay Expressway ("SBX") for the design, construction and operation of a private-public partnership project in San Diego County. SBX contracted with Otay River Constructors ("ORC") for the design and construction of the project, consisting of: 1) the privately-funded toll road initially contemplated by the parties; and 2) the publicly and privately funded gap and connector project to connect the toll road to existing state highways. ORC sued SBX, alleging cost overruns on the gap/connector project were caused by SBX, and SBX cross-complained against Caltrans for breach of contract and indemnification, seeking \$295 million in damages. In separate pending arbitration relating to the toll road, SBX is seeking approximately \$278 million in damages based on the same theories as in the gap/connector litigation. ORC has filed a motion to join this arbitration with the litigation. Both matters are currently stayed after SBX filed for bankruptcy.

BANK ARRANGEMENTS

The table immediately following the text of Appendix A, prior to the State Debt Tables, includes certain information relating to bank arrangements the state has entered into. See also "STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing – Bank Arrangements."

STATE DEBT TABLES

The tables which follow provide information on outstanding state debt, authorized but unissued general obligation bonds and commercial paper notes, debt service requirements for state general obligation and lease-revenue bonds, and authorized and outstanding state revenue bonds. The table titled "Bank Arrangements" contains certain information relating to letters of credit, liquidity facilities and other bank arrangements in connection with variable rate obligations. Also, see "STATE INDEBTEDNESS AND OTHER OBLIGATIONS." For purposes of these tables, "General Fund bonds," also known as "non-self liquidating bonds," are general obligation bonds expected to be paid from the General Fund without reimbursement from any other fund. Although the principal of general obligation commercial paper notes in the "non-self liquidating" category is legally payable from the General Fund, the state expects that principal of such commercial paper notes will be paid only from the issuance of new commercial paper notes or the issuance of long-term general obligation bonds to retire the commercial

paper notes. Interest on “non-self liquidating” general obligation commercial paper notes is payable from the General Fund.

“Enterprise Fund bonds,” also known as “self liquidating bonds,” are general obligation bonds for which program revenues are expected to be sufficient to reimburse in full the General Fund for debt service payments, but any failure to make such a reimbursement does not affect the obligation of the state to pay principal and interest on the bonds from the General Fund.

“Special Revenue Fund bonds” also known as Economic Recovery Bonds or ERBs, are “self liquidating” general obligation bonds which are primarily secured by a pledge of a one-quarter cent statewide sales and use tax deposited in the Fiscal Recovery Fund. Debt service payments are made directly from the Fiscal Recovery Fund and not the General Fund. The Special Revenue Fund bonds are also general obligations of the state to which the full faith and credit of the state are pledged to the punctual payment of the principal of and interest thereon, if the sales tax revenues are insufficient.

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BANK ARRANGEMENTS (See “STATE INDEBTEDNESS AND OTHER OBLIGATIONS – Capital Facilities Financing - Bank Arrangements.”)

<u>Program</u>	<u>Series</u>	<u>Outstanding Par Amount</u>	<u>Credit Provider</u>	<u>Expiration</u>	<u>Type of Credit</u>	<u>Reset Mode</u>
GO VRDOs	2003A 1	\$50,000,000	JP Morgan Chase	12/1/2010	LOC	Daily
	2003A 2-3	\$200,000,000	Bank of Montreal	12/1/2012	LOC	Daily
GO VRDOs	2003B 1-4	\$250,000,000	BNP Paribas (60.0%)	12/1/2010	LOC	Weekly
			CA Public Employees' Retirement System (20.0%)	12/1/2010		Weekly
			CA State Teachers Retirement Syst. (20.0%)	12/1/2010		Weekly
GO VRDOs	2003C 1	\$100,000,000	Bank of America, N.A.	12/1/2011	LOC	Weekly
	2003C 2	\$100,000,000	Bank of Nova Scotia	12/1/2010	LOC	Weekly
	2003C 3-4	\$100,000,000	Citibank, N.A.	12/1/2012	LOC	Weekly
GO VRDOs	2004A 1, 4 & 5	\$200,000,000	Citibank, N.A. (75%)	10/15/2012	LOC	Daily
			CA State Teachers Retirement Syst. (25%)	10/15/2012		
GO VRDOs	2004A 2 & 3	\$150,000,000	State Street Bank & Trust Company (75%)	10/15/2012	LOC	Daily
			CA State Teachers Retirement Syst. (25%)	10/15/2012		
GO VRDOs	2004A 6, 7, 8 & 10	\$200,000,000	Citibank, N.A. (75.0%)	10/15/2012	LOC	Weekly
			CA State Teachers Retirement Syst. (25%)	10/15/2012		
GO VRDOs	2004 A 9	\$50,000,000	State Street Bank & Trust Company (75%)	10/15/2012	LOC	Weekly
			CA State Teachers Retirement Syst. (25%)	10/15/2012		
GO VRDOs	2004B 1-3	\$165,000,000	Citibank, N.A.	10/15/2012	LOC	Daily
GO VRDOs	2004B 4-6	\$135,000,000	Citibank, N.A.	10/15/2012	LOC	Weekly
GO VRDOs	2005A-1	\$171,600,000	Fortis Bank	11/17/2010	LOC	Weekly
GO VRDOs	2005A-2	\$171,600,000	Credit Agricole Corporate & Investment Bank (formerly Calyon)	11/17/2010	LOC	Weekly
GO VRDOs	2005A-3	\$49,100,000	Bank of America	11/17/2010	LOC	Weekly
GO VRDOs	2005B-1	\$147,100,000	Bank of America	11/17/2010	LOC	Weekly
GO VRDOs	2005B-2	\$98,100,000	Societe General	11/17/2010	LOC	Weekly
GO VRDOs	2005B-3	\$49,100,000	JP Morgan Chase	11/17/2010	LOC	Weekly
GO VRDOs	2005B-4	\$49,100,000	JP Morgan Chase	11/17/2010	LOC	Weekly
GO VRDOs	2005B-5	\$88,890,000	Depfa Bank	11/17/2010	LOC	Weekly
GO VRDOs	2005B-6	\$98,100,000	KBC Bank	11/17/2010	LOC	Daily
GO VRDOs	2005B-7	\$49,100,000	Landesbank Hessen-Thuringen Girozentrale (Helaba)	11/17/2010	LOC	Daily
ERB VRDOs	2004C-1	\$100,000,000	Bank of America	6/15/2012	LOC	Daily
ERB VRDOs	2004C-2	\$50,000,000	Bank of America	6/15/2012	LOC	Daily
ERB VRDOs	2004C-3	\$100,000,000	Bank of America	6/15/2012	LOC	Daily
ERB VRDOs	2004C-4	\$150,000,000	JP Morgan Chase	6/15/2012	LOC	Daily
ERB VRDOs	2004C-5	\$100,000,000	Bank of America	6/15/2012	LOC	Daily
ERB VRDOs	2004C-11	\$152,395,000	BNP Paribas	6/15/2012	LOC	Weekly
ERB VRDOs	2004C-15	\$237,285,000	Dexia Local/FSA Insurance	6/15/2011	SBPA	Weekly
ERB VRDOs	2004C-16	\$185,090,000	Dexia Local/ FSA Insurance	6/15/2011	SBPA	Weekly
GO CP	N/A	\$2,000,000,000 ^(a)	Royal Bank of Canada (21.735%) Dexia Credit Local (21.735%) Wells Fargo Bank, N.A. (18.48%) CA Public Employees Retirement Sys. (10.87%) Credit Agricole Corporate & Investment Bank (formerly Calyon) (10.87%) CA State Teachers Retirement Sys (8.70%) Landesbank Hessen-Thuringen Girozentrale (Helaba) (7.61%)	10/30/2012	LOC	Up to 90 days
Total Par		\$5,746,560,000				

^(a) For commercial paper (CP), the total par outstanding represents the maximum commitment. The bank group is responsible for the total CP outstanding.

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OUTSTANDING STATE DEBT
FISCAL YEARS 2004-05 THROUGH 2008-09
(Dollars in Thousands Except for Per Capita Information)

	<u>2004-05</u>	<u>2005-06</u>	<u>2006-07</u>	<u>2007-08</u>	<u>2008-09</u>
Outstanding Debt (a)					
General Obligation Bonds					
General Fund (Non-Self Liquidating).....	\$ 34,643,757	\$ 37,066,227	\$ 41,275,412	\$ 45,465,459	\$ 59,037,759
Enterprise Fund (Self Liquidating).....	\$ 2,084,505	\$ 1,960,105	\$ 1,950,920	\$ 1,905,490	\$ 1,655,265
Special Revenue Fund (Self Liquidating).....	\$ 10,727,305	\$ 9,759,490	\$ 8,291,010	\$ 9,120,285	\$ 8,223,450
Total.....	\$ 47,455,567	\$ 48,785,822	\$ 51,517,342	\$ 56,491,234	\$ 68,916,474
Lease-Purchase Debt.....	\$ 7,841,383	\$ 7,785,005	\$ 7,738,011	\$ 7,833,069	\$ 8,051,007
Total Outstanding General Obligation Bonds and Lease-Purchase Debt.....	\$ 55,296,950	\$ 56,570,827	\$ 59,255,353	\$ 64,324,303	\$ 76,967,481
Bond Sales During Fiscal Year (b)					
Non-Self Liquidating General Obligation Bonds....	\$ 4,914,740	\$ 5,516,560	\$ 10,226,550	\$ 8,748,685	\$ 13,934,985
Self Liquidating General Obligation Bonds.....	\$ 221,475	\$ 0	\$ 359,160	\$ 91,200	\$ 0
Self Liquidating Special Fund Revenue Bonds.....	\$ 0	\$ 0	\$ 0	\$ 3,179,260	\$ 0
Lease-Purchase Debt.....	\$ 907,955	\$ 1,112,595	\$ 995,920	\$ 489,700	\$ 641,975
Debt Service (c)					
Non-Self Liquidating General Obligation Bonds....	\$ 3,048,739	\$ 3,121,563	\$ 3,259,041	\$ 4,032,601	\$ 4,081,518
Lease-Purchase Debt.....	\$ 740,976	\$ 804,311	\$ 774,947	\$ 791,371	\$ 825,788
General Fund Receipts (d).....	\$ 87,936,942	\$ 94,302,567	\$ 97,357,252	\$ 103,416,171	\$ 87,774,952
Non-Self Liquidating General Obligation Bonds					
Debt Service as a Percentage of General Fund Receipts.....	3.47%	3.31%	3.35%	3.90%	4.65%
Lease-Purchase Debt Service as a Percentage of General Fund Receipts.....	0.84%	0.85%	0.80%	0.77%	0.94%
Population (e).....	36,506,000	37,005,000	37,444,000	37,771,000	38,148,000
Non-Self Liquidating General Obligation Bonds					
Outstanding per Capita.....	\$ 948.99	\$ 1,001.65	\$ 1,102.32	\$ 1,203.71	\$ 1,547.60
Lease-Purchase Debt Outstanding per Capita.....	\$ 214.80	\$ 210.38	\$ 206.66	\$ 207.38	\$ 211.05
Personal Income (f).....	\$1,262,306,000	\$1,338,181,000	\$1,420,245,000	\$1,519,547,000	\$1,569,370,000
Non-Self Liquidating General Obligation Bonds					
Outstanding as Percentage of Personal Income.....	2.74%	2.77%	2.91%	2.99%	3.76%
Lease-Purchase Debt Outstanding as Percentage of Personal Income.....	0.62%	0.58%	0.54%	0.52%	0.51%

(a) As of last day of fiscal year. Includes the initial value of capital appreciation bonds rather than the accreted value.

(b) Includes refunding bonds.

(c) Calculated on a cash basis. Debt service costs of bonds issued in any fiscal year largely appear in subsequent fiscal year.

(d) Calculated on a cash basis. General Fund Receipts includes both revenues and nonrevenues, such as borrowings the proceeds of which are deposited in the General Fund (e.g. tobacco securitization bonds).

(e) As of July 1, the beginning of the fiscal year.

(f) Source: U.S. Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov/>

Annual Totals: "Pre-benchmark" Revisions: Estimates as of March 24, 2009. California Department of Finance.

SOURCES: Population: State of California, Department of Finance.

Personal Income: State of California, Department of Finance; United States, Department of Commerce, Bureau of Economic Analysis (BEA).

Outstanding Debt, Bonds Sales During Fiscal Year and Debt Service: State of California, Office of the Treasurer.

General Fund Receipts: State of California, Office of the State Controller.

AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS
As of May 1, 2010
(Thousands)

	Voter Authorization Date	Voter Authorization Amount \$	Long Term Bonds Outstanding (a) \$	Long Term Bonds Unissued (b) \$
GENERAL FUND BONDS (Non-Self Liquidating)				
1988 School Facilities Bond Act	11/08/88	800,000	129,210	2,255
1990 School Facilities Bond Act	06/05/90	800,000	207,490	2,125
1992 School Facilities Bond Act	11/03/92	900,000	403,889	1,789
California Clean Water, Clean Air, Safe Neighborhood Parks, and Coastal Protection Act of 2002	03/05/02	2,600,000	2,170,575	389,060
California Library Construction and Renovation Bond Act of 1988	11/08/88	75,000	26,800	2,595
* California Park and Recreational Facilities Act of 1984	06/05/84	370,000	30,765	1,100
* California Parklands Act of 1980	11/04/80	285,000	6,490	0
California Reading and Literacy Improvement and Public Library Construction and Renovation Bond Act of 2000	03/07/00	350,000	267,050	40,785
* California Safe Drinking Water Bond Law of 1976	06/08/76	175,000	10,465	2,500
* California Safe Drinking Water Bond Law of 1984	11/06/84	75,000	5,265	0
* California Safe Drinking Water Bond Law of 1986	11/04/86	100,000	35,560	0
California Safe Drinking Water Bond Law of 1988	11/08/88	75,000	39,695	580
* California Wildlife, Coastal, and Park Land Conservation Act	06/07/88	776,000	201,370	7,330
Children's Hospital Bond Act of 2004	11/02/04	750,000	659,430	85,715
Children's Hospital Bond Act of 2008	11/04/08	980,000	525,320	454,680
Class Size Reduction Kindergarten-University Public Education Facilities Bond Act of 1998 (Higher Education)	11/03/98	2,500,000	2,134,755	0
Class Size Reduction Kindergarten-University Public Education Facilities Bond Act of 1998 (K-12)	11/03/98	6,700,000	5,128,960	11,860
Clean Air and Transportation Improvement Bond Act of 1990	06/05/90	1,990,000	1,074,780	99,580
* Clean Water Bond Law of 1970	11/03/70	250,000	500	0
* Clean Water Bond Law of 1974	06/04/74	250,000	1,485	0
* Clean Water Bond Law of 1984	11/06/84	325,000	22,195	0
* Clean Water and Water Conservation Bond Law of 1978	06/06/78	375,000	8,240	0
Clean Water and Water Reclamation Bond Law of 1988	11/08/88	65,000	32,820	0
* Community Parklands Act of 1986	06/03/86	100,000	9,285	0
* County Correctional Facility Capital Expenditure Bond Act of 1986	06/03/86	495,000	57,105	0
County Correctional Facility Capital Expenditure and Youth Facility Bond Act of 1988	11/08/88	500,000	153,155	0

AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS
As of May 1, 2010
(Thousands)

	Voter Authorization Date	Voter Authorization Amount \$	Long Term Bonds Outstanding (a) \$	Long Term Bonds Unissued (b) \$
GENERAL FUND BONDS (Non-Self Liquidating)				
* County Jail Capital Expenditure Bond Act of 1981	11/02/82	280,000	800	0
Disaster Preparedness and Flood Prevention Bond Act of 2006	11/07/06	4,090,000	1,577,470	2,512,060
Earthquake Safety and Public Buildings Rehabilitation Bond Act of 1990	06/05/90	300,000	182,070	12,410
* Fish and Wildlife Habitat Enhancement Act of 1984	06/05/84	85,000	8,750	0
* Higher Education Facilities Bond Act of 1986	11/04/86	400,000	3,800	0
Higher Education Facilities Bond Act of 1988	11/08/88	600,000	89,705	0
Higher Education Facilities Bond Act of June 1990	06/05/90	450,000	115,285	550
Higher Education Facilities Bond Act of June 1992	06/02/92	900,000	470,235	1,305
Highway Safety, Traffic Reduction, Air Quality, and Port Security Bond Act of 2006	11/07/06	19,925,000	6,952,215	12,952,510
Housing and Emergency Shelter Trust Fund Act of 2002	11/05/02	2,100,000	1,759,070	191,270
Housing and Emergency Shelter Trust Fund Act of 2006	11/07/06	2,850,000	1,472,595	1,377,405
Housing and Homeless Bond Act of 1990	06/05/90	150,000	3,790	0
Kindergarten-University Public Education Facilities Bond Act of 2002 (Hi-Ed)	11/05/02	1,650,000	1,558,010	8,820
Kindergarten-University Public Education Facilities Bond Act of 2002 (K-12)	11/05/02	11,400,000	9,904,560	645,150
Kindergarten-University Public Education Facilities Bond Act of 2004 (Hi-Ed)	03/02/04	2,300,000	2,094,760	167,505
Kindergarten-University Public Education Facilities Bond Act of 2004 (K-12)	03/02/04	10,000,000	8,066,975	1,738,630
Kindergarten-University Public Education Facilities Bond Act of 2006 (Hi-Ed)	11/07/06	3,087,000	2,492,255	593,305
Kindergarten-University Public Education Facilities Bond Act of 2006 (K-12)	11/07/06	7,329,000	3,604,520	3,717,595
* Lake Tahoe Acquisitions Bond Act	08/02/82	85,000	4,660	0
* New Prison Construction Bond Act of 1986	11/04/86	500,000	26,025	0
New Prison Construction Bond Act of 1988	11/08/88	817,000	111,435	3,170
New Prison Construction Bond Act of 1990	06/05/90	450,000	100,765	605
Passenger Rail and Clean Air Bond Act of 1990	06/05/90	1,000,000	285,640	0
Public Education Facilities Bond Act of 1996 (Higher Education)	03/26/96	975,000	669,025	37,465
Public Education Facilities Bond Act of 1996 (K-12)	03/26/96	2,025,000	1,287,935	12,965
Safe Drinking Water, Clean Water, Watershed Protection, and Flood Protection Act	03/07/00	1,970,000	1,510,575	277,190
Safe Drinking Water, Water Quality and Supply, Flood Control, River and Coastal Protection Bond Act of 2006	11/07/06	5,388,000	2,038,940	3,348,140
Safe Neighborhood Parks, Clean Water, Clean Air, and Coastal Protection Bond Act of 2000	03/07/00	2,100,000	1,686,275	172,900

AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS
As of May 1, 2010
(Thousands)

	Voter Authorization Date	Voter Authorization Amount \$	Long Term Bonds Outstanding (a) \$	Long Term Bonds Unissued (b) \$
GENERAL FUND BONDS (Non-Self Liquidating)				
Safe, Clean, Reliable Water Supply Act	11/05/96	995,000	733,885	101,820
Safe, Reliable High-Speed Passenger Train Bond Act for the 21st Century	11/04/08	9,950,000	258,395	9,691,605
* School Building and Earthquake Bond Act of 1974	11/05/74	40,000	22,645	0
School Facilities Bond Act of 1988	06/07/88	800,000	47,335	0
School Facilities Bond Act of 1990	11/06/90	800,000	282,870	0
School Facilities Bond Act of 1992	06/02/92	1,900,000	845,145	10,280
Seismic Retrofit Bond Act of 1996	03/26/96	2,000,000	1,532,955	0
* State School Building Lease-Purchase Bond Law of 1984	11/06/84	450,000	4,600	0
* State School Building Lease-Purchase Bond Law of 1986	11/04/86	800,000	20,550	0
* State, Urban, and Coastal Park Bond Act of 1976	11/02/76	280,000	6,555	0
Stem Cell Research and Cures Bond Act of 2004	11/02/04	3,000,000	1,028,545	1,971,455
Veterans Homes Bond Act of 2000	03/07/00	50,000	40,345	975
Voting Modernization Bond Act of 2002	03/05/02	200,000	72,880	64,495
Water Conservation Bond Law of 1988	11/08/88	60,000	31,595	5,235
* Water Conservation and Water Quality Bond Law of 1986	06/03/86	150,000	50,230	15,535
Water Security, Clean Drinking Water, Coastal and Beach Protection Act of 2002	11/05/02	3,440,000	2,518,105	843,745
Total General Fund Bonds		<u>130,782,000</u>	<u>68,917,429</u>	<u>41,578,049</u>
ENTERPRISE FUND BONDS (Self-Liquidating)				
* California Water Resources Development Bond Act	11/08/60	1,750,000	483,315	167,600
Veterans Bond Act of 1984	11/06/84	650,000	22,820	0
Veterans Bond Act of 1986	06/03/86	850,000	173,295	0
Veterans Bond Act of 1988	06/07/88	510,000	169,010	0
Veterans Bond Act of 1990	11/06/90	400,000	143,545	0
Veterans Bond Act of 1996	11/05/96	400,000	242,665	0
Veterans Bond Act of 2000	11/07/00	500,000	225,890	263,610
Veterans Bond Act of 2008	11/04/08	900,000	0	900,000
Total Enterprise Fund Bonds		<u>5,960,000</u>	<u>1,460,540</u>	<u>1,331,210</u>

AUTHORIZED AND OUTSTANDING GENERAL OBLIGATION BONDS

As of May 1, 2010

(Thousands)

	Voter Authorization Date	Voter Authorization Amount \$	Long Term Bonds Outstanding (a) \$	Long Term Bonds Unissued (b) \$
<hr/>				
SPECIAL REVENUE FUND BONDS (Self Liquidating)				
* Economic Recovery Bond Act	04/10/04	15,000,000	8,061,170	0
Total Special Revenue Fund Bonds		<u>15,000,000</u>	<u>8,061,170</u>	<u>0</u>
TOTAL GENERAL OBLIGATION BONDS		<u>151,742,000</u>	<u>78,439,139</u>	<u>42,909,259</u>

(a) Includes the initial value of capital appreciation bonds rather than the accreted value.

(b) A portion of unissued bonds may be issued initially in the form of commercial paper notes, as authorized from time to time by the respective Finance Committees. A total of not more than \$2 billion of commercial paper principal plus accrued interest may be owing at one time. See "STATE INDEBTEDNESS AND OTHER OBLIGATIONS - Capital Facilities Financing -- Commercial Paper Program" above. Bond acts marked with an asterisk (*) are not legally permitted to utilize commercial paper.

SOURCE: State of California, Office of the Treasurer.

**GENERAL OBLIGATION AND REVENUE BONDS
SUMMARY OF DEBT SERVICE REQUIREMENTS
As of May 1, 2010**

	Total Debt		
	Interest	Principal (a)	Total
GENERAL OBLIGATION BONDS			
<u>GENERAL FUND NON-SELF LIQUIDATING (b)</u>			
Fixed Rate	\$ 60,939,078,240.26	\$ 65,197,759,045.16	\$ 126,136,837,285.42
Variable Rate (c)	1,368,828,594.82	3,719,670,000.00	5,088,498,594.82
<u>ENTERPRISE FUND SELF LIQUIDATING</u>			
Fixed Rate	822,112,342.75	1,460,540,000.00	2,282,652,342.75
<u>SPECIAL REVENUE FUND SELF LIQUIDATING (d)</u>			
Fixed Rate	2,195,397,023.75	6,486,400,000.00	8,681,797,023.75
Variable Rate (e)	249,183,652.21	1,574,770,000.00	1,823,953,652.21
REVENUE BONDS			
<u>GENERAL FUND LEASE REVENUE</u>			
Lease-Purchase	6,062,277,724.84	9,971,245,000.00	16,033,522,724.84
<u>PROPOSITION 1A RECEIVABLES PROGRAM</u>			
Revenue	324,358,760.00	1,895,000,000.00	2,219,358,760.00
General Fund and Lease Revenue Total (f)	<u>\$ 71,961,236,338.63</u>	<u>\$ 90,305,384,045.16</u>	<u>\$ 162,266,620,383.79</u>

(a) Includes scheduled mandatory sinking fund payments.

(b) Does not include outstanding commercial paper.

(c) The estimate of future interest payments is based on rates in effect as of May 1, 2010. The interest rates for the daily and weekly rate bonds range from .17 - .65%. The 2009 Stem Cell Bonds, 2009B and 2009C Highway Safety, Traffic Reduction, Air Quality and Port Security Private Placement Bonds, the 2009A Solano County Private Placement Bonds and the 2009A UC Private Placement Bonds currently bear interest at fixed rates of 5.65%, 3.77%, 3.30%, 3.18%, and 3.183% respectively, until reset date, and are assumed to bear those rates from reset until maturity.

(d) Economic Recovery Bonds.

(e) The estimate of future interest payments is based on rates in effect as of May 1, 2010. The interest rates for the daily and weekly rate bonds range from .18 - .36%. \$500,000,000 of the series 2009B Economic Recovery Bonds bear interest at fixed rates ranging from 3.50 - 5.00% until reset date, and are assumed to bear interest at the rate of 4.00% from each reset date to maturity.

(f) Estimated interest included.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR GENERAL FUND NON-SELF LIQUIDATING BONDS**

Fixed Rate

As of May 1, 2010

Fiscal Year Ending June 30	Current Debt		
	Interest (a)	Principal (b)	Total
2010	\$ 167,736,909.73	\$ 151,125,000.00	\$ 318,861,909.73 (c)
2011	3,518,361,827.26	2,007,599,045.16	5,525,960,872.42
2012	3,434,790,228.69	1,931,030,000.00	5,365,820,228.69
2013	3,343,472,625.95	1,599,315,000.00	4,942,787,625.95
2014	3,264,690,148.39	2,226,410,000.00	5,491,100,148.39
2015	3,157,030,742.50	2,336,360,000.00	5,493,390,742.50
2016	3,046,112,415.00	2,003,435,000.00	5,049,547,415.00
2017	2,945,494,427.79	1,802,860,000.00	4,748,354,427.79
2018	2,856,095,592.12	1,760,125,000.00	4,616,220,592.12
2019	2,766,722,649.27	1,883,495,000.00	4,650,217,649.27
2020	2,647,866,726.65	2,220,430,000.00	4,868,296,726.65
2021	2,548,866,108.96	1,827,315,000.00	4,376,181,108.96
2022	2,455,406,595.94	1,915,400,000.00	4,370,806,595.94
2023	2,357,206,436.98	1,872,920,000.00	4,230,126,436.98
2024	2,265,774,719.29	1,686,855,000.00	3,952,629,719.29
2025	2,179,565,744.34	1,893,325,000.00	4,072,890,744.34
2026	2,080,869,571.70	2,006,075,000.00	4,086,944,571.70
2027	1,972,714,853.64	2,028,635,000.00	4,001,349,853.64
2028	1,871,431,603.12	2,219,300,000.00	4,090,731,603.12
2029	1,762,653,756.25	2,190,385,000.00	3,953,038,756.25
2030	1,652,320,807.96	2,448,440,000.00	4,100,760,807.96
2031	1,531,658,126.56	2,070,470,000.00	3,602,128,126.56
2032	1,427,436,305.00	2,305,075,000.00	3,732,511,305.00
2033	1,305,230,145.00	2,259,295,000.00	3,564,525,145.00
2034	1,183,189,298.80	3,387,935,000.00	4,571,124,298.80
2035	948,977,041.25	2,830,030,000.00	3,779,007,041.25
2036	777,804,138.26	2,679,740,000.00	3,457,544,138.26
2037	610,615,071.97	2,625,870,000.00	3,236,485,071.97
2038	452,133,153.14	2,410,635,000.00	2,862,768,153.14
2039	333,518,600.00	3,093,990,000.00	3,427,508,600.00
2040	73,331,868.75	1,523,885,000.00	1,597,216,868.75
Total	\$ 60,939,078,240.26	\$ 65,197,759,045.16	\$ 126,136,837,285.42

(a) The amounts do not reflect any interest subsidy under the Build America Bonds program. Subsidy not pledged to the repayment of debt service.

(b) Includes scheduled mandatory sinking fund payments.

(c) Total represents the remaining estimated debt service requirements from June 1, 2010 through June 30, 2010.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR GENERAL FUND NON-SELF LIQUIDATING BONDS
Variable Rate
As of May 1, 2010**

Fiscal Year Ending June 30	Current Debt		
	Interest (a)(b)	Principal (c)	Total
2010	\$ 577,548.11	\$ -	\$ 577,548.11 (d)
2011	57,215,712.37	-	57,215,712.37
2012	54,099,087.00	-	54,099,087.00
2013	54,115,628.80	-	54,115,628.80
2014	54,067,527.00	-	54,067,527.00
2015	54,067,527.00	-	54,067,527.00
2016	54,092,069.65	32,000,000.00	86,092,069.65
2017	53,910,258.38	326,945,000.00	380,855,258.38
2018	52,918,926.89	431,245,000.00	484,163,926.89
2019	51,702,071.00	197,450,000.00	249,152,071.00
2020	51,077,142.04	184,250,000.00	235,327,142.04
2021	50,568,473.81	108,600,000.00	159,168,473.81
2022	50,312,358.53	58,000,000.00	108,312,358.53
2023	50,158,124.07	88,200,000.00	138,358,124.07
2024	49,916,685.76	270,600,000.00	320,516,685.76
2025	49,237,297.69	174,200,000.00	223,437,297.69
2026	48,780,656.29	318,000,000.00	366,780,656.29
2027	48,057,006.72	46,100,000.00	94,157,006.72
2028	47,938,710.15	49,700,000.00	97,638,710.15
2029	47,801,903.49	87,500,000.00	135,301,903.49
2030	47,094,906.78	106,440,000.00	153,534,906.78
2031	45,439,730.97	129,335,000.00	174,774,730.97
2032	43,466,243.96	132,435,000.00	175,901,243.96
2033	41,483,123.56	135,335,000.00	176,818,123.56
2034	39,511,310.29	54,235,000.00	93,746,310.29
2035	37,731,653.62	52,635,000.00	90,366,653.62
2036	35,955,643.25	52,635,000.00	88,590,643.25
2037	34,179,592.44	52,635,000.00	86,814,592.44
2038	32,403,582.07	52,635,000.00	85,038,582.07
2039	30,627,558.22	557,600,000.00	588,227,558.22
2040	320,534.93	20,960,000.00	21,280,534.93
Total	\$ 1,368,828,594.82	\$ 3,719,670,000.00	\$ 5,088,498,594.82

- (a) The estimate of future interest payments is based on rates in effect as of May 1, 2010. The interest rates for the daily and weekly rate bonds range from .17 - .65%. The 2009 Stem Cell Bonds, 2009B and 2009C Highway Safety, Traffic Reduction, Air Quality and Port Security Private Placement Bonds, the 2009A Solano County Private Placement Bonds and the 2009A UC Private Placement Bonds currently bear interest at fixed rates of 5.65%, 3.77%, 3.30%, 3.18%, and 3.183% respectively, until reset date, and are assumed to bear those rates from reset until maturity.
- (b) The amounts do not reflect any interest subsidy under the Build America Bonds program. Subsidy not pledged to the repayment of debt service.
- (c) Includes scheduled mandatory sinking fund payments for the 2009 Stem Cell Bonds, the Series 2009B and 2009C of the Highway Safety, Traffic Reduction, Air Quality and Port Security Private Placement Bonds, the 2009A Solano County Private Placement Bonds and the 2009A UC Private Placement Bonds.
- (d) Total represents the remaining estimated debt service requirements from June 1, 2010 through June 30, 2010.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR STATE OF CALIFORNIA PROPOSITION 1A RECEIVABLES PROGRAM^(a)
REVENUE BONDS
Fixed Rate
As of May 1, 2010**

Fiscal Year Ending June 30	Current Debt		
	Interest	Principal	Total
2010	\$ 51,958,760.00	\$ -	\$ 51,958,760.00 (b)
2011	90,800,000.00	-	90,800,000.00
2012	90,800,000.00	-	90,800,000.00
2013	90,800,000.00	1,895,000,000.00	1,985,800,000.00
Total	\$ 324,358,760.00	\$ 1,895,000,000.00	\$ 2,219,358,760.00

(a) Bonds were issued by the California Statewide Communities Development Authority pursuant to Article 4 (commencing with Section 6584) of Chapter 5 of Division 7 of Title 1 of the Government Code of the State of California.

(b) Total represents the remaining estimated debt service requirements from June 1, 2010 through June 30, 2010.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS FOR
SPECIAL REVENUE FUND SELF LIQUIDATING BONDS**

**Fixed Rate
As of May 1, 2010**

Fiscal Year Ending June 30	Current Debt		
	Interest	Principal (a)	Total
2010	\$ -	\$ -	\$ - (b)
2011	315,832,132.50	439,955,000.00	755,787,132.50
2012	294,816,967.50	240,330,000.00	535,146,967.50
2013	278,116,960.00	476,470,000.00	754,586,960.00
2014	253,545,855.00	500,470,000.00	754,015,855.00
2015	227,360,123.75	525,615,000.00	752,975,123.75
2016	199,987,330.00	556,690,000.00	756,677,330.00
2017	172,061,875.00	584,210,000.00	756,271,875.00
2018	142,939,488.75	612,540,000.00	755,479,488.75
2019	113,287,497.50	592,955,000.00	706,242,497.50
2020	86,381,762.50	496,145,000.00	582,526,762.50
2021	61,485,062.50	507,445,000.00	568,930,062.50
2022	36,945,093.75	451,575,000.00	488,520,093.75
2023	12,591,250.00	500,000,000.00	512,591,250.00
2024	45,625.00	2,000,000.00	2,045,625.00
Total	\$ 2,195,397,023.75	\$ 6,486,400,000.00	\$ 8,681,797,023.75

(a) Includes scheduled mandatory sinking fund payments.

(b) Total represents the remaining estimated debt service requirements from June 1, 2010 through June 30, 2010.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS FOR
SPECIAL REVENUE FUND SELF LIQUIDATING BONDS**

**Variable Rate
As of May 1, 2010**

Fiscal Year Ending June 30	Current Debt		
	Interest (a)	Principal (b)	Total
2010	\$ 222,574.92	\$ -	\$ 222,574.92 (c)
2011	26,650,224.00	-	26,650,224.00
2012	26,654,711.57	-	26,654,711.57
2013	26,661,086.43	-	26,661,086.43
2014	26,642,549.00	-	26,642,549.00
2015	24,718,124.00	-	24,718,124.00
2016	22,805,861.57	-	22,805,861.57
2017	22,796,886.43	-	22,796,886.43
2018	22,801,374.00	25,000,000.00	47,801,374.00
2019	21,316,723.99	115,000,000.00	136,316,723.99
2020	15,400,511.57	189,500,000.00	204,900,511.57
2021	7,519,193.98	240,155,000.00	247,674,193.98
2022	3,209,904.67	219,190,000.00	222,399,904.67
2023	1,685,218.96	419,420,000.00	421,105,218.96
2024	98,707.11	366,505,000.00	366,603,707.11
Total	\$ 249,183,652.21	\$ 1,574,770,000.00	\$ 1,823,953,652.21

(a) The estimate of future interest payments is based on rates in effect as of May 1, 2010. The interest rates for the daily and weekly rate bonds range from .18 - .36%. \$500,000,000 of the series 2009B Economic Recovery Bonds bear interest at fixed rates ranging from 3.50 - 5.00% until reset date, and are assumed to bear interest at the rate of 4.00% from each reset date to maturity.

(b) Includes scheduled mandatory sinking fund payments.

(c) Total represents the remaining estimated debt service requirements from June 1, 2010 through June 30, 2010.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR ENTERPRISE FUND SELF LIQUIDATING BONDS**

**Fixed Rate
As of May 1, 2010**

Fiscal Year Ending June 30	Current Debt		
	Interest	Principal (a)	Total
2010	\$ 26,325,788.67	\$ 6,400,000.00	\$ 32,725,788.67 (b)
2011	66,864,213.27	86,480,000.00	153,344,213.27
2012	62,266,561.00	99,615,000.00	161,881,561.00
2013	58,309,396.00	78,390,000.00	136,699,396.00
2014	54,462,337.25	98,960,000.00	153,422,337.25
2015	50,644,667.50	76,445,000.00	127,089,667.50
2016	47,180,618.15	73,830,000.00	121,010,618.15
2017	44,097,545.13	61,895,000.00	105,992,545.13
2018	40,910,021.49	73,815,000.00	114,725,021.49
2019	37,149,603.92	85,080,000.00	122,229,603.92
2020	33,786,877.36	52,590,000.00	86,376,877.36
2021	31,116,133.75	45,615,000.00	76,731,133.75
2022	28,773,350.03	41,240,000.00	70,013,350.03
2023	27,185,822.62	20,690,000.00	47,875,822.62
2024	26,078,422.38	25,145,000.00	51,223,422.38
2025	24,674,311.71	32,470,000.00	57,144,311.71
2026	23,239,696.05	26,825,000.00	50,064,696.05
2027	21,909,018.65	28,940,000.00	50,849,018.65
2028	20,514,605.30	29,490,000.00	50,004,605.30
2029	18,695,830.30	46,130,000.00	64,825,830.30
2030	16,324,896.19	52,400,000.00	68,724,896.19
2031	13,861,787.28	50,490,000.00	64,351,787.28
2032	11,371,757.50	53,235,000.00	64,606,757.50
2033	8,761,341.25	55,095,000.00	63,856,341.25
2034	6,889,425.00	22,940,000.00	29,829,425.00
2035	5,786,720.00	23,560,000.00	29,346,720.00
2036	4,731,100.00	21,210,000.00	25,941,100.00
2037	3,670,842.50	23,885,000.00	27,555,842.50
2038	2,756,210.00	15,590,000.00	18,346,210.00
2039	2,028,212.50	16,330,000.00	18,358,212.50
2040	1,257,530.00	17,110,000.00	18,367,530.00
2041	450,087.50	17,925,000.00	18,375,087.50
2042	28,050.00	350,000.00	378,050.00
2043	9,562.50	375,000.00	384,562.50
Total	\$ 822,112,342.75	\$ 1,460,540,000.00	\$ 2,282,652,342.75

(a) Includes scheduled mandatory sinking fund payments.

(b) Total represents the remaining estimated debt service requirements from June 1, 2010 through June 30, 2010.

SOURCE: State of California, Office of the Treasurer.

**SCHEDULE OF DEBT SERVICE REQUIREMENTS
FOR LEASE-PURCHASE DEBT**

**Fixed Rate
As of May 1, 2010**

Fiscal Year Ending June 30	Current Debt		
	Interest (a)	Principal (b)	Total
2010	\$ 75,677,768.98	\$ 83,645,000.00	\$ 159,322,768.98 (c)
2011	512,520,374.16	460,470,000.00	972,990,374.16
2012	495,875,683.49	456,785,000.00	952,660,683.49
2013	473,550,326.05	483,720,000.00	957,270,326.05
2014	449,223,020.20	510,475,000.00	959,698,020.20
2015	423,393,890.32	535,190,000.00	958,583,890.32
2016	396,623,581.88	525,545,000.00	922,168,581.88
2017	369,804,676.59	538,170,000.00	907,974,676.59
2018	342,611,419.67	559,140,000.00	901,751,419.67
2019	314,649,639.45	528,080,000.00	842,729,639.45
2020	287,918,642.71	508,940,000.00	796,858,642.71
2021	263,296,001.20	457,430,000.00	720,726,001.20
2022	239,730,203.33	440,100,000.00	679,830,203.33
2023	218,309,540.75	400,850,000.00	619,159,540.75
2024	198,317,716.13	327,230,000.00	525,547,716.13
2025	181,094,870.06	344,460,000.00	525,554,870.06
2026	163,234,543.32	344,535,000.00	507,769,543.32
2027	144,390,317.60	363,370,000.00	507,760,317.60
2028	124,442,938.38	367,595,000.00	492,037,938.38
2029	104,835,813.79	319,840,000.00	424,675,813.79
2030	86,992,738.82	300,625,000.00	387,617,738.82
2031	70,057,388.41	255,565,000.00	325,622,388.41
2032	54,587,907.75	239,695,000.00	294,282,907.75
2033	39,039,859.95	229,840,000.00	268,879,859.95
2034	23,594,827.23	211,880,000.00	235,474,827.23
2035	8,504,034.62	178,070,000.00	186,574,034.62
Total	\$ 6,062,277,724.84	\$ 9,971,245,000.00	\$ 16,033,522,724.84

(a) The amounts do not reflect any interest subsidy under the Build America Bonds program. Subsidy not pledged to the repayment of debt service.

(b) Includes scheduled mandatory sinking fund payments.

(c) Total represents the remaining estimated debt service requirements from June 1, 2010 through June 30, 2010.

SOURCE: State of California, Office of the Treasurer.

**STATE PUBLIC WORKS BOARD AND
OTHER LEASE-PURCHASE FINANCING
OUTSTANDING ISSUES
As of May 1, 2010**

<u>Name of Issue</u>	<u>Outstanding</u>
 <u>GENERAL FUND SUPPORTED ISSUES:</u>	
State Public Works Board	
California Community Colleges	\$ 492,285,000
California Department of Corrections and Rehabilitations	2,337,655,000
Office of Energy Assessments (a)	7,960,000
The Regents of the University of California (b)	2,350,585,000
Trustees of the California State University	841,785,000
Various State Office Buildings	3,414,625,000
	<hr/>
Total State Public Works Board Issues	\$ 9,444,895,000
Total Other State Building Lease Purchase Issues (c)	\$ 526,350,000
	<hr/>
Total General Fund Supported Issues	\$ 9,971,245,000
 <u>SPECIAL FUND SUPPORTED ISSUES:</u>	
East Bay State Building Authority*	\$ 42,777,519
San Bernardino Joint Powers Financing Authority	39,770,000
San Francisco State Building Authority (d)	17,835,000
	<hr/>
Total Special Fund Supported Issues	\$ 100,382,519
TOTAL	\$ 10,071,627,519
	<hr/> <hr/>

* Includes the initial value of capital appreciation bonds rather than the accreted value.

(a) This program is self-liquidating based on energy cost savings.

(b) The Regents' obligations to the State Public Works Board are payable from lawfully available funds of The Regents which are held in The Regents' treasury funds are separate from the State General Fund. A portion of The Regents' annual budget is derived from General Fund appropriations.

(c) Includes \$134,670,000 Sacramento City Financing Authority Lease Revenue Bonds State of California - Cal/EPA Building, 1998 Series A, which are supported by lease rentals from the California Environmental Protection Agency; these rental payments are subject to annual appropriation by the State Legislature.

(d) The sole tenant is the California Public Utilities Commission.

SOURCE: State of California, Office of the Treasurer.

**STATE AGENCY REVENUE BONDS
AND CONDUIT FINANCING
As of December 31, 2009**

<u>Issuing Agency</u>	<u>Outstanding</u>^{(a)(b)}
<u>State Programs Financing:</u>	
California Alternative Energy and Advanced Transportation Financing Authority.....	\$ 18,666,667
California Department of Transportation - GARVEE.....	467,645,000
California Infrastructure and Economic Development Bank.....	1,109,090,000
California State University.....	3,084,073,000
Department of Water Resources - Central Valley Project.....	2,421,185,000
Department of Water Resources - Power Supply Program.....	9,029,520,000
The Regents of the University of California.....	9,092,935,000
<u>Housing Financing:</u>	
California Housing Finance Agency.....	7,990,097,517
Veterans Revenue Debenture.....	680,255,000
<u>Conduit Financing:</u>	
California Alternative Energy and Advanced Transportation Financing Authority.....	52,710,000
California Earthquake Authority.....	220,500,000
California Educational Facilities Authority.....	4,624,586,060
California Health Facilities Financing Authority.....	9,119,135,887
California Infrastructure and Economic Development Bank	4,154,956,999
California Pollution Control Financing Authority.....	3,848,394,038
California Student Loan Authority.....	21,590,000
TOTAL.....	<u>\$ 55,935,340,168</u>

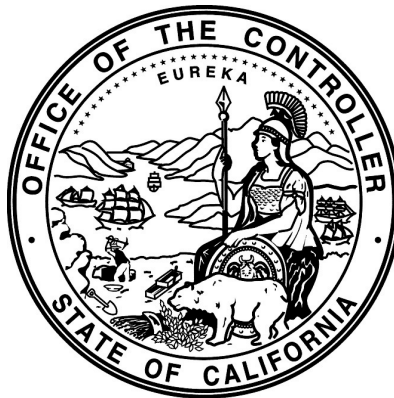
(a) Totals for California Department of Transportation, California State University, Department of Water Resources and Veterans Revenue Debenture were provided by the State of California, Office of the Treasurer. All other totals were provided by the listed issuing agency.

(b) Does not include the Tobacco Settlement Revenue Bonds issued by Golden State Tobacco Securitization Corporation.

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STATEMENT of GENERAL FUND CASH RECEIPTS and DISBURSEMENTS

May 2010



JOHN CHIANG
California State Controller



JOHN CHIANG
California State Controller

June 9, 2010

Users of the Statement of General Fund Cash Receipts and Disbursements:

Enclosed is the Statement of General Fund Cash Receipts and Disbursements for the period July 1, 2009 through May 31, 2010. This statement reflects the State of California's General Fund cash position and compares actual receipts and disbursements for the 2009-10 fiscal year to cash flow estimates prepared by the Department of Finance for the Amended 2009-10 Budget Act. The statement is prepared in compliance with Provision 8 of Budget Act item 0840-001-0001, using records compiled by the State Controller. Prior year actual amounts are also displayed for comparative purposes.

Attachment A compares actual receipts and disbursements to date for the 2009-10 fiscal year to cash flow estimates published in the 2010-11 May Revision. These cash flow estimates are predicated on projections and assumptions made by the Department of Finance in preparation of the May Revision.

Attachment B compares actual receipts and disbursements to date for the 2009-10 fiscal year to cash flow estimates prepared by the Department of Finance based upon the Amended 2009 Budget Act.

These statements are also available on the Internet at the State Controller's website at www.sco.ca.gov under the category Monthly Financial Reports.

Any questions concerning this report may be directed to Michael Havey, Division Chief of Accounting and Reporting, at (916) 327-4144.

Sincerely,

Original signed by:

JOHN CHIANG
California State Controller

STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
A Comparison of Actual to 2010-11 May Revision Estimates
(Amounts in thousands)

	July 1 through May 31					
	2010				2009	
	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual	
			Amount	%		
GENERAL FUND BEGINNING CASH BALANCE	\$ -	\$ -	\$ -	-	\$ -	
Add Receipts:						
Revenues	75,249,128	74,656,959	592,169	0.8	72,625,526	
Nonrevenues	1,906,782	1,897,879	8,903	(e) 0.5	2,556,005	
Total Receipts	77,155,910	76,554,838	601,072	0.8	75,181,531	
Less Disbursements:						
State Operations	22,040,991	22,171,614	(130,623)	(e) (0.6)	24,949,291	
Local Assistance	59,899,576	60,883,050	(983,474)	(e) (1.6)	67,393,290	
Capital Outlay	1,454,533	1,465,014	(10,481)	(0.7)	1,245,359	
Nongovernmental	444,209	474,767	(30,558)	(6.4)	(72,078)	
Total Disbursements	83,839,309	84,994,445	(1,155,136)	(1.4)	93,515,862	
Receipts Over / (Under) Disbursements	(6,683,399)	(8,439,607)	1,756,208	-	(18,334,331)	
Net Increase / (Decrease) in Temporary Loans	6,683,399	8,439,607	(1,756,208)	(20.8)	18,334,331	
GENERAL FUND ENDING CASH BALANCE	-	-	-	-	-	
Special Fund for Economic Uncertainties	-	-	-	-	-	
TOTAL CASH	\$ -	\$ -	\$ -	-	\$ -	
Borrowable Resources						
Available Borrowable Resources	\$ 26,339,264	\$ 25,272,737	\$ 1,066,527	(d) 4.2	\$ 24,255,797	
Outstanding Loans (b)	18,591,484	20,347,695	(1,756,211)	(8.6)	19,786,089	
Unused Borrowable Resources	\$ 7,747,780	\$ 4,925,042	\$ 2,822,738	57.3	\$ 4,469,708	

General Note:

This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of in-transit items.

Footnotes:

- (a) A Statement of Estimated Cash Flow for the 2009-10 fiscal year was prepared by the Department of Finance for the 2010-11 May Revision. Any projections or estimates are set forth as such and not as representation of facts.
- (b) Outstanding loan balance of \$18.6 billion is comprised of \$12.6 billion of internal borrowing and \$6.0 billion of external borrowing. Current balance is comprised of \$11.9 carried forward from June 30, 2009 plus current year Net Increase/Decrease in Temporary Loans of \$6.7 billion.
- (c) Negative variances are the result of repayments received that are greater than disbursements made.
- (d) On September 29, 2009, \$8.8 billion of Revenue Anticipation Notes proceeds were received and \$2.8 billion was repaid on May 25, 2010. The \$1.5 billion interim RAN issued August 27, 2009 was repaid on September 29, 2009.
- (e) These amounts reflect the receipt of funds from the County Office of Education pursuant to Revenue and Tax Code Section 100.06, as added by Chapter 14, Statutes of 2009 (AB x4 15, Gaines) as offsets to General Fund expenditures in accordance with control Section 15.45 of the Budget Act of 2009. The total non-revenue receipts of approximately \$1,170 million were applied to the following expenditures: \$605 million to Administrative Office of the Courts (\$418 million in January, \$125 million in February and \$62 million in May), \$249 million to California Department of Corrections and Rehabilitation (\$169 million in January, \$50 million in February and \$30 million in May), \$314 million to Health Care Services Medi-Cal Assistance (\$156 million in January, \$47 million in February and \$111 million in May), and \$2 million to Department of Developmental Services all in May. May Revision estimated \$96 million receipts in May. Actuals for May totaled \$205 million.

SCHEDULE OF CASH RECEIPTS

(Amounts in thousands)

	July 1 through May 31						
	Month of May		2010				2009
	2010	2009	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
REVENUES							
Alcoholic Beverage Excise Tax	\$ 28,550	\$ 28,682	\$ 296,725	\$ 299,175	\$ (2,450)	(0.8)	\$ 307,736
Corporation Tax	308,283	243,086	7,502,483	7,418,200	84,283	1.1	7,771,252
Cigarette Tax	15,322	9,378	94,951	87,629	7,322	8.4	106,141
Estate, Inheritance, and Gift Tax	137	4,116	4,889	4,752	137	2.9	17,064
Insurance Companies Tax	73,034	13,359	1,647,340	1,603,306	44,034	2.7	1,653,120
Personal Income Tax	2,382,462	1,590,057	38,823,833	38,431,371	392,462	1.0	39,195,944
Retail Sales and Use Taxes	3,546,564	3,151,394	24,143,150	24,070,586	72,564	0.3	21,215,684
Vehicle Licence Fees	109,379	-	1,259,358	1,270,979	(11,621)	(0.9)	-
Pooled Money Investment Interest	2,484	3,903	15,862	16,378	(516)	(3.2)	194,955
Not Otherwise Classified	141,954	241,837	1,460,537	1,454,583	5,954	-	2,163,630
Total Revenues	6,608,169	5,285,812	75,249,128	74,656,959	592,169	0.8	72,625,526
NONREVENUES							
Transfers from Special Fund for Economic Uncertainties	-	-	1,060,834	1,060,834	-	-	837,902
Transfers from Other Funds	2,331	9,376	262,468	268,220	(5,752)	(2.1)	1,075,243
Miscellaneous	117,860	162,582	583,480	568,825	14,655	2.6	642,860
Total Nonrevenues	120,191	171,958	1,906,782	1,897,879	8,903	0.5	2,556,005
Total Receipts	\$ 6,728,360	\$ 5,457,770	\$ 77,155,910	\$ 76,554,838	\$ 601,072	0.8	\$ 75,181,531

See notes on page 1.

SCHEDULE OF CASH DISBURSEMENTS

(Amounts in thousands)

	July 1 through May 31						
	Month of May		2010				2009
	2010	2009	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
STATE OPERATIONS (c)							
Legislative/Judicial/Executive	\$ 171,072	\$ 48,762	\$ 1,325,607	\$ 1,384,048	\$ (58,441)	(4.2)	\$ 1,362,109
State and Consumer Services	46,045	38,516	450,078	430,932	19,146	4.4	485,836
Business, Transportation and Housing	105	517	2,595	(17,136)	19,731	-	4,526
Resources	94,125	95,912	1,041,598	1,084,634	(43,036)	(4.0)	1,476,995
Environmental Protection Agency	1,126	5,389	43,765	51,342	(7,577)	(14.8)	60,867
Health and Human Services:							
Health Services	15,032	1,007	205,960	188,074	17,886	9.5	217,757
Mental Health	91,449	126,418	999,209	993,133	6,076	0.6	1,111,046
Other Health and Human Services	35,217	(14,591)	503,018	547,803	(44,785)	(8.2)	586,213
Education:							
University of California	281,454	265,635	1,662,072	1,660,046	2,026	0.1	2,848,106
State Universities and Colleges	478,663	18	1,630,223	1,635,611	(5,388)	(0.3)	2,875,311
Other Education	12,355	11,696	148,940	153,077	(4,137)	(2.7)	152,584
Dept. of Corrections and Rehabilitation	731,151	331,501	7,784,956	7,941,106	(156,150) (e)	(2.0)	8,502,401
General Government	126,690	78,015	1,452,188	1,299,705	152,483	11.7	1,418,096
Public Employees Retirement							
System	(130,724)	(136,333)	149,374	151,098	(1,724)	(1.1)	158,862
Debt Service	144,007	162,544	4,523,423	4,605,419	(81,996)	(1.8)	3,624,293
Interest on Loans	55,263	37,797	117,985	62,722	55,263	88.1	64,289
Total State Operations	2,153,030	1,052,803	22,040,991	22,171,614	(130,623)	(0.6)	24,949,291
LOCAL ASSISTANCE (c)							
Public Schools - K-12	1,387,647	1,796,405	27,740,993	28,306,454	(565,461)	(2.0)	30,927,406
Community Colleges	323,875	289,722	3,618,205	3,604,694	13,511	0.4	3,781,298
Debt Service-School Building Bonds	-	-	-	-	-	-	-
Contributions to State Teachers'							
Retirement System	-	-	1,248,045	1,248,045	-	-	1,133,088
Other Education	111,507	159,851	3,350,233	3,446,296	(96,063)	(2.8)	3,542,514
Dept. of Corrections and Rehabilitation	3,341	10,333	201,672	201,798	(126)	(0.1)	269,263
Dept. of Alcohol and Drug Program	15,530	21,919	202,203	151,933	50,270	33.1	276,530
Dept. of Health Services:							
Medical Assistance Program	556,343	980,819	10,570,559	10,987,514	(416,955) (e)	(3.8)	11,717,236
Other Health Services	10,704	28,439	271,864	311,500	(39,636)	(12.7)	366,804
Dept. of Developmental Services	(46,551)	(109,049)	1,937,302	2,011,607	(74,305) (e)	(3.7)	2,283,904
Dept. of Mental Health	75,726	(10,733)	673,721	648,413	25,308	3.9	856,936
Dept. of Social Services:							
SSI/SSP/IHSS	166,621	24,071	4,329,299	4,254,146	75,153	1.8	4,700,955
CalWORKs	159,666	230,906	2,304,384	2,260,276	44,108	2.0	2,754,683
Other Social Services	140,316	46,355	1,385,526	1,342,981	42,545	3.2	1,332,359
Tax Relief	65,809	99,100	439,725	435,432	4,293	1.0	480,894
Other Local Assistance	18,773	132,857	1,625,845	1,671,961	(46,116) (e)	(2.8)	2,969,420
Total Local Assistance	2,989,307	3,700,995	59,899,576	60,883,050	(983,474)	(1.6)	67,393,290

See notes on page 1.

(Continued)

SCHEDULE OF CASH DISBURSEMENTS (Continued)

(Amounts in thousands)

	Month of May		July 1 through May 31				2009
	2010	2009	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
CAPITAL OUTLAY	1,524	58,605	1,454,533	1,465,014	(10,481)	(0.7)	1,245,359
NONGOVERNMENTAL (c)							
Transfer to Special Fund for Economic Uncertainties	-	-	-	-	-	-	-
Transfer to Budget Stabilization Account	-	-	-	-	-	-	-
Transfer to Other Funds	20,798	-	1,027,542	1,042,744	(15,202)	(1.5)	510,866
Transfer to Revolving Fund	(18,391)	(37,507)	14,903	10,653	4,250	39.9	30,633
Advance:							
MediCal Provider Interim Payment	-	-	-	-	-	-	-
State-County Property Tax							
Administration Program	(22,464)	(23,228)	(25,246)	(13,592)	(11,654)	-	(61,765)
Social Welfare Federal Fund	2,858	(1,378)	(26,719)	(46,597)	19,878	-	(2,019)
Tax Relief and Refund Account	-	-	-	27,830	(27,830)	(100.0)	-
Counties for Social Welfare	-	-	(546,271)	(546,271)	-	-	(549,793)
Total Nongovernmental	(17,199)	(62,113)	444,209	474,767	(30,558)	(6.4)	(72,078)
Total Disbursements	\$ 5,126,662	\$ 4,750,290	\$ 83,839,309	\$ 84,994,445	\$ (1,155,136)	(1.4)	\$ 93,515,862
TEMPORARY LOANS							
Special Fund for Economic Uncertainties	\$ -	\$ -	\$ (1,060,835)	\$ (1,060,835)	\$ -	-	\$ 87,814
Budget Stabilization Account	-	-	-	-	-	-	-
Outstanding Registered Warrants Account	-	-	-	-	-	-	-
Other Internal Sources	1,223,302	492,520	1,769,234	3,563,119	(1,793,885)	(50.3)	13,946,517
Revenue Anticipation Notes	(2,825,000)	(1,200,000)	5,975,000	5,937,323	37,677 (d)	0.6	4,300,000
Net Increase / (Decrease) Loans	\$ (1,601,698)	\$ (707,480)	\$ 6,683,399	\$ 8,439,607	\$ (1,756,208)	(20.8)	\$ 18,334,331

See notes on page 1.

(Concluded)

COMPARATIVE STATEMENT OF REVENUES RECEIVED
All Governmental Cost Funds
(Amounts in thousands)

	July 1 through May 31			
	General Fund		Special Funds	
	2010	2009	2010	2009
MAJOR TAXES, LICENSES, AND INVESTMENT INCOME:				
Alcoholic Beverage Excise Taxes	\$ 296,725	\$ 307,736	\$ -	\$ -
Corporation Tax	7,502,483	7,771,252	-	-
Cigarette Tax	94,951	106,141	808,437	899,121
Estate, Inheritance, and Gift Tax	4,889	17,064	-	-
Insurance Companies Tax	1,647,340	1,653,120	200,052	-
Motor Vehicle Fuel Tax:				
Gasoline Tax	-	-	2,437,747	2,431,398
Diesel & Liquid Petroleum Gas	-	-	450,194	473,214
Jet Fuel Tax	-	-	2,039	2,539
Vehicle License Fees	1,259,358	84,620	1,801,202	1,938,376
Motor Vehicle Registration and Other Fees	-	-	3,170,540	3,004,222
Personal Income Tax	38,823,833	39,195,944	693,526	709,747
Retail Sales and Use Taxes	24,143,150	21,215,684	5,896,856	7,341,833
Pooled Money Investment Interest	15,862	194,955	627	1,393
Total Major Taxes, Licenses, and Investment Income	73,788,591	70,546,516	15,461,220	16,801,843
NOT OTHERWISE CLASSIFIED:				
Alcoholic Beverage License Fee	2,663	3,308	44,092	40,739
Electrical Energy Tax	-	-	694,065	649,106
Private Rail Car Tax	5,814	6,035	-	-
Penalties on Traffic Violations	-	-	75,065	79,478
Health Care Receipts	11,519	13,495	-	-
Revenues from State Lands	241,824	366,519	-	-
Abandoned Property	(97,040)	388,632	-	-
Trial Court Revenues	57,886	60,874	1,610,052	1,361,994
Horse Racing Fees	1,326	2,301	11,891	26,281
Miscellaneous	1,236,545	1,237,846	5,698,589	6,121,946
Not Otherwise Classified	1,460,537	2,079,010	8,133,754	8,279,544
Total Revenues, All Governmental Cost Funds	\$ 75,249,128	\$ 72,625,526	\$ 23,594,974	\$ 25,081,387

See notes on page 1.

STATEMENT OF GENERAL FUND CASH RECEIPTS AND DISBURSEMENTS
A Comparison of Actual to Amended 2009 Budget Act Estimates
(Amounts in thousands)

	July 1 through May 31				
	2010				2009
	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
			Amount	%	
GENERAL FUND BEGINNING CASH BALANCE	\$ -	\$ -	\$ -	-	\$ -
Add Receipts:					
Revenues	75,249,128	76,907,917	(1,658,789)	(2.2)	72,625,526
Nonrevenues	1,906,782	1,895,085	11,697 (h)	0.6	2,556,005
Total Receipts	77,155,910	78,803,002	(1,647,092)	(2.1)	75,181,531
Less Disbursements:					
State Operations	22,040,991	19,822,688	2,218,303 (h)	11.2	24,949,291
Local Assistance	59,899,576	59,115,533	784,043 (h)	1.3	67,393,290
Capital Outlay	1,454,533	1,774,572	(320,039)	(18.0)	1,245,359
Nongovernmental	444,209	78,279	365,930	467.5	(72,078)
Total Disbursements	83,839,309	80,791,072	3,048,237	3.8	93,515,862
Receipts Over / (Under) Disbursements	(6,683,399)	(1,988,070)	(4,695,329)	-	(18,334,331)
Net Increase / (Decrease) in Temporary Loans	6,683,399	1,988,070	4,695,329	236.2	18,334,331
GENERAL FUND ENDING CASH BALANCE	-	-	-	-	-
Special Fund for Economic Uncertainties	-	-	-	-	-
TOTAL CASH	\$ -	\$ -	\$ -	-	\$ -
BORROWABLE RESOURCES					
Available Borrowable Resources	\$ 26,339,264	\$ 26,479,333	\$ (140,069) (d)	(0.5)	\$ 24,255,797
Outstanding Loans (b)	18,591,484	13,896,178	4,695,306	33.8	19,786,089
Unused Borrowable Resources	\$ 7,747,780	\$ 12,583,155	\$ (4,835,375)	(38.4)	\$ 4,469,708

General Note:

This report is based upon funded cash. Funded cash is cash reported to and recorded in the records of the State Controller's Office. Amounts reported as funded cash may differ from amounts in other reports to the extent there are timing differences in the recording of in-transit items.

Footnotes:

- (a) A Statement of Estimated Cash Flow for the 2009-10 fiscal year was prepared by the Department of Finance for the Amended 2009 Budget Act. Any projections or estimates are set forth as such and not as representation of facts.
- (b) Outstanding loan balance of \$18.6 billion is comprised of \$12.6 billion of internal borrowing and \$6.0 billion of external borrowing. Current balance is comprised of \$11.9 carried forward from June 30, 2009 plus current year Net Increase/Decrease in Temporary Loans of \$6.7 billion.
- (c) Negative variances are the result of repayments received that are greater than disbursements made.
- (d) On September 29, 2009, \$8.8 billion of Revenue Anticipation Notes proceeds were received and \$2.8 billion was repaid on May 25, 2010. The \$1.5 billion interim RAN issued August 27, 2009 was repaid on September 29, 2009.
- (e) The University of California received \$198 million in ARRA funds in October not included in the Amended 2009 Budget Act cash flow estimates.
- (f) The State Universities and Colleges received \$270 million in ARRA funds in October not included in the Amended 2009 Budget Act cash flow estimates.
- (g) Subsequent to the release of the Amended 2009 Budget Act cash flow estimates, the Department of Social Services indicated that the CalWORKS program is projected to spend less than the published estimate for 2009-10 fiscal year.
- (h) These amounts reflect the receipt of funds from the County Office of Education pursuant to Revenue and Tax Code Section 100.06, as added by Chapter 14, Statutes of 2009 (AB x4 15, Gaines) as offsets to General Fund expenditures in accordance with control Section 15.45 of the Budget Act of 2009. The total non-revenue receipts of approximately \$1,170 million were applied to the following expenditures: \$605 million to Administrative Office of the Courts (\$418 million in January, \$125 million in February and \$62 million in May), \$249 million to California Department of Corrections and Rehabilitation (\$169 million in January, \$50 million in February and \$30 million in May), \$314 million to Health Care Services Medi-Cal Assistance (\$156 million in January, \$47 million in February and \$111 million in May), and \$2 million to Department of Developmental Services all in May. May Revision estimated \$96 million receipts in May. Actuals for May totaled \$205 million.

SCHEDULE OF CASH RECEIPTS
 (Amounts in thousands)

	July 1 through May 31						
	Month of May		2010				2009
	2010	2009	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
REVENUES							
Alcoholic Beverage Excise Tax	\$ 28,550	\$ 28,682	\$ 296,725	\$ 306,000	\$ (9,275)	(3.0)	\$ 307,736
Corporation Tax	308,283	243,086	7,502,483	6,816,044	686,439	10.1	7,771,252
Cigarette Tax	15,322	9,378	94,951	102,014	(7,063)	(6.9)	106,141
Estate, Inheritance, and Gift Tax	137	4,116	4,889	488	4,401	901.8	17,064
Insurance Companies Tax	73,034	13,359	1,647,340	1,530,000	117,340	7.7	1,653,120
Personal Income Tax	2,382,462	1,590,057	38,823,833	43,115,004	(4,291,171)	(10.0)	39,195,944
Retail Sales and Use Taxes	3,546,564	3,151,394	24,143,150	24,632,300	(489,150)	(2.0)	21,215,684
Vehicle Licence Fees	109,379	-	1,259,358	1,512,035	(252,677)	(16.7)	-
Pooled Money Investment Interest	2,484	3,903	15,862	70,000	(54,138)	(77.3)	194,955
Not Otherwise Classified	141,954	241,837	1,460,537	(1,175,968)	2,636,505	-	2,163,630
Total Revenues	6,608,169	5,285,812	75,249,128	76,907,917	(1,658,789)	(2.2)	72,625,526
NONREVENUES							
Transfers from Special Fund for Economic Uncertainties	-	-	1,060,834	1,039,571	21,263	2.0	837,902
Transfers from Other Funds	2,331	9,376	262,468	412,000	(149,532)	(36.3)	1,075,243
Miscellaneous	117,860	162,582	583,480	443,514	139,966	31.6	642,860
Total Nonrevenues	120,191	171,958	1,906,782	1,895,085	11,697	0.6	2,556,005
Total Receipts	\$ 6,728,360	\$ 5,457,770	\$ 77,155,910	\$ 78,803,002	\$ (1,647,092)	(2.1)	\$ 75,181,531

See notes on page 1.

SCHEDULE OF CASH DISBURSEMENTS
 (Amounts in thousands)

	Month of May		July 1 through May 31					2009
			2010		Actual Over or (Under) Estimate			
	2010	2009	Actual	Estimate (a)			Actual	
					Amount	%		
STATE OPERATIONS (c)								
Legislative/Judicial/Executive	\$ 171,072	\$ 48,762	\$ 1,325,607	\$ 1,312,504	\$ 13,103		1.0	\$ 1,362,109
State and Consumer Services	46,045	38,516	450,078	540,755	(90,677)		(16.8)	485,836
Business, Transportation and Housing	105	517	2,595	454,930	(452,335)		(99.4)	4,526
Resources	94,125	95,912	1,041,598	899,029	142,569		15.9	1,476,995
Environmental Protection Agency	1,126	5,389	43,765	72,521	(28,756)		(39.7)	60,867
Health and Human Services:								
Health Services	15,032	1,007	205,960	240,239	(34,279)		(14.3)	217,757
Mental Health	91,449	126,418	999,209	1,223,586	(224,377)		(18.3)	1,111,046
Other Health and Human Services	35,217	(14,591)	503,018	655,924	(152,906)		(23.3)	586,213
Education:								
University of California	281,454	265,635	1,662,072	1,697,200	(35,128)	(e)	(2.1)	2,848,106
State Universities and Colleges	478,663	18	1,630,223	1,622,400	7,823	(f)	0.5	2,875,311
Other Education	12,355	11,696	148,940	169,811	(20,871)		(12.3)	152,584
Dept. of Corrections and Rehabilitation	731,151	331,501	7,784,956	7,165,026	619,930	(h)	8.7	8,502,401
General Government	126,690	78,015	1,452,188	(1,132,542)	2,584,730		-	1,418,096
Public Employees Retirement								
System	(130,724)	(136,333)	149,374	147,451	1,923		1.3	158,862
Debt Service	144,007	162,544	4,523,423	4,582,854	(59,431)		(1.3)	3,624,293
Interest on Loans	55,263	37,797	117,985	171,000	(53,015)		(31.0)	64,289
Total State Operations	2,153,030	1,052,803	22,040,991	19,822,688	2,218,303		11.2	24,949,291
LOCAL ASSISTANCE (c)								
Public Schools - K-12	1,387,647	1,796,405	27,740,993	28,372,808	(631,815)		(2.2)	30,927,406
Community Colleges	323,875	289,722	3,618,205	3,638,244	(20,039)		(0.6)	3,781,298
Debt Service-School Building Bonds	-	-	-	(864)	864		-	-
Contributions to State Teachers'								
Retirement System	-	-	1,248,045	1,248,055	(10)		(0.0)	1,133,088
Other Education	111,507	159,851	3,350,233	2,763,785	586,448		21.2	3,542,514
Dept. of Corrections and Rehabilitation	3,341	10,333	201,672	170,567	31,105		18.2	269,263
Dept. of Alcohol and Drug Program	15,530	21,919	202,203	204,156	(1,953)		(1.0)	276,530
Dept. of Health Services:								
Medical Assistance Program	556,343	980,819	10,570,559	9,690,749	879,810	(h)	9.1	11,717,236
Other Health Services	10,704	28,439	271,864	167,080	104,784		62.7	366,804
Dept. of Developmental Services	(46,551)	(109,049)	1,937,302	1,886,620	50,682	(h)	2.7	2,283,904
Dept. of Mental Health	75,726	(10,733)	673,721	529,066	144,655		27.3	856,936
Dept. of Social Services:								
SSI/SSP/IHSS	166,621	24,071	4,329,299	3,911,835	417,464		10.7	4,700,955
CalWORKs	159,666	230,906	2,304,384	2,575,080	(270,696)	(g)	(10.5)	2,754,683
Other Social Services	140,316	46,355	1,385,526	1,382,410	3,116		0.2	1,332,359
Tax Relief	65,809	99,100	439,725	454,226	(14,501)		(3.2)	480,894
Other Local Assistance	18,773	132,857	1,625,845	2,121,716	(495,871)	(h)	(23.4)	2,969,420
Total Local Assistance	2,989,307	3,700,995	59,899,576	59,115,533	784,043		1.3	67,393,290

See notes on page 1.

(Continued)

SCHEDULE OF CASH DISBURSEMENTS (Continued)

(Amounts in thousands)

	July 1 through May 31						
	Month of May		2010				2009
	2010	2009	Actual	Estimate (a)	Actual Over or (Under) Estimate		Actual
					Amount	%	
CAPITAL OUTLAY	1,524	58,605	1,454,533	1,774,572	(320,039)	(18.0)	1,245,359
NONGOVERNMENTAL (c)							
Transfer to Special Fund for Economic Uncertainties	-	-	-	-	-	-	-
Transfer to Budget Stabilization Account	-	-	-	-	-	-	-
Transfer to Other Funds	20,798	-	1,027,542	640,350	387,192	60.5	510,866
Transfer to Revolving Fund	(18,391)	(37,507)	14,903	(35,979)	50,882	-	30,633
Advance:							
MediCal Provider Interim Payment	-	-	-	-	-	-	-
State-County Property Tax Administration Program	(22,464)	(23,228)	(25,246)	30,118	(55,364)	(183.8)	(61,765)
Social Welfare Federal Fund	2,858	(1,378)	(26,719)	(9,939)	(16,780)	-	(2,019)
Tax Relief and Refund Account	-	-	-	-	-	-	-
Counties for Social Welfare	-	-	(546,271)	(546,271)	-	-	(549,793)
Total Nongovernmental	(17,199)	(62,113)	444,209	78,279	365,930	467.5	(72,078)
Total Disbursements	\$ 5,126,662	\$ 4,750,290	\$ 83,839,309	\$ 80,791,072	\$ 3,048,237	3.8	\$ 93,515,862
TEMPORARY LOANS							
Special Fund for Economic Uncertainties	\$ -	\$ -	\$ (1,060,835)	\$ (1,039,571)	\$ (21,264)	-	\$ 87,814
Budget Stabilization Account	-	-	-	-	-	-	-
Outstanding Registered Warrants Account	-	-	-	-	-	-	-
Other Internal Sources	1,223,302	492,520	1,769,234	(4,772,359)	6,541,593	-	13,946,517
Revenue Anticipation Notes	(2,825,000)	(1,200,000)	5,975,000	7,800,000	(1,825,000) (d)	(23.4)	4,300,000
Net Increase / (Decrease) Loans	\$ (1,601,698)	\$ (707,480)	\$ 6,683,399	\$ 1,988,070	\$ 4,695,329	236.2	\$ 18,334,331

See notes on page 1.

(Concluded)

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APPENDIX B
THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA,
THE PROGRAM AND THE 1943 FUND

INTRODUCTION

This Appendix B includes information about the Department, its Program, the 1943 Fund (including audited financial statements) and the Department's allocation of receipts from Contracts of Purchase, including Excess Revenues. Capitalized terms not defined herein shall have the meanings ascribed to them in the Official Statement.

Forward-Looking Statements

As further described in the forepart of this Official Statement under "INTRODUCTION – Information Related to this Official Statement," investors should note that historical information presented in this Appendix B is not an indicator of future performance. Statements contained herein that are not purely historical are forward-looking statements. All forward-looking statements included in this Appendix B are based on information available to the Department as of the date hereof, and the Department assumes no obligation to update any such forward-looking statements. It is important to note that actual results could differ materially from those in such forward-looking statements. Assumptions related to forward-looking statements involve judgments with respect to, among other things, future economic and market conditions and future business decisions, all of which are difficult or impossible to predict and many of which are beyond the control of the Department.

THE DEPARTMENT

General

In 1921, the California Legislature (the "Legislature") created the Veterans' Welfare Board and the Program. The Department of Veterans Affairs became the successor to the Veterans' Welfare Board under the Veterans' Farm and Home Purchase Act of 1943 (the "1943 Act"). The Department is a subdivision of the State and constitutes a public corporation. One of the Department's basic objectives is to provide eligible veterans the opportunity to acquire homes with long-term low-interest financing provided under the Program. See "THE PROGRAM."

Governance of the Department

The California Veterans Board (the "Board") advises the Department on policies for all operational matters. The Board is composed of seven members appointed by the Governor and subject to Senate confirmation. Each member of the Board must be a veteran. One member must be retired from the active or reserve forces of the United States military service. One member must have substantial training or professional expertise in mortgage lending and real estate finance. One member must have substantial training or professional expertise in geriatrics, gerontology or long-term care. One member must have an accounting or auditing background and preferably be a certified public accountant. Each of the foregoing four members serves four-year terms. Finally, one member must be a resident of one of the State veterans homes run by the Department which were established for qualified aged and disabled veterans and their spouses. This member serves only a two-year term. There is presently one vacancy on the Board.

Certain actions of the Department, for example, certain actions relating to interest rates on Contracts of Purchase, require the approval of the Veterans' Finance Committee of 1943, which is comprised of the Governor, the State Treasurer, the State Controller, the State Director of Finance and the Secretary of the Department (the "Veterans' Finance Committee"). See "THE PROGRAM – Contracts of Purchase – Interest Rates." Certain actions of the Department require the approval of the Veterans' Debenture Finance Committee comprised of the Governor, the State Treasurer, the State Controller, the State Director of Finance and the Secretary of the Department. Members of the Board sit on various committees including policy and procedures, legislative, communication, administrative, home and veterans services.

Administration of the Department

There are four principal divisions within the Department: the Division of Veterans Services, the Division of Administration, the Veterans' Home Division and the Division of Farm and Home Purchases. The Program is administered by the Division of Farm and Home Purchases with support from the Division of Administration and other Department support units. See "THE PROGRAM."

General administration of the Program, including fiscal, legal, personnel and other administrative functions, is performed at the Department's headquarters in Sacramento California. The Division of Farm and Home Purchases also maintains field offices located throughout the State. See "THE PROGRAM."

The Secretary is appointed by the Governor of the State, serves at the pleasure of the Governor and must be a veteran. The Secretary and other senior staff personnel of the Department principally responsible for the administration of the Program are listed below. As of March 31, 2010, the Department employed approximately 128 persons in support of the Program. For a discussion of certain litigation regarding furloughs of Department staff, see "THE 1943 FUND – Selected Financial Data of the 1943 Fund and Department's Discussion – Fiscal Year Ended June 30, 2009."

Roger L. Brautigan
Secretary since November 2009

Mr. Brautigan is a 33-year veteran of the U.S. Army, achieving the rank of Major General while serving in a variety of active and reserve command and staff positions in the United States, Vietnam and Germany. His command assignments ranged from Platoon leader to both company and battalion level commands. Most recently he served as deputy commanding general and chief of staff, I Corps and Fort Lewis in Fort Lewis, Washington. Mr. Brautigan holds a Bachelor of Science degree from the University of Arizona at Tucson and a Master's degree from the University of the Pacific at Stockton, California. He is a graduate of the Armor, Infantry, and Adjutant General Officer Advanced Courses, Army Command and General Staff College, and the Army War College. Mr. Brautigan's military awards and decorations include the Defense Distinguished Service Medal, the Distinguished Service Medal, the Legion of Merit (with oak leaf cluster), the Bronze Star Medal, the Defense Meritorious Service Medal, the Meritorious Service Medal (with 3 oak leaf clusters), the Army Commendation Medal (with 3 oak leaf clusters), the Army Achievement Medal (with oak leaf cluster), various service and unit awards, and the Army General Staff Identification Badge.

Rocky Chavez
Undersecretary since November 2009

Mr. Chavez was appointed Undersecretary in November 2009. Previously, Mr. Chavez served on the Oceanside City Council since November of 2002. Mr. Chavez was commissioned in the United States Marine Corps on January 1, 1974. Following his commission, he served in all four Marine Divisions around the world. In his Marine Corps career he has risen from commanding three men in a Forward Observer billet to being Chief of Staff for the 4th Marine Division. His last billet was Assistant Chief of Staff for Logistics, Camp Pendleton. Mr. Chavez is a graduate of the Air War College, Armed Forces Staff College, and Marine Corps Command and Staff College. He also attended Old Dominion University where he studied International Relations. Mr. Chavez retired from the Marine Corps on September 1, 2001.

Jim Lowrey
Deputy Secretary for Farm and Home Purchases since March 2009

Jim Lowrey has over 29 years of financial experience in auditing, accounting and bond finance. He started as the Chief of Bond Finance at the Department in January 2007 and was promoted to Deputy Secretary for Farm and Home Purchases, which division includes bond finance and investment, in March 2009. The previous five years were spent at the State Treasurer's Office managing the General Obligation bond program where he was responsible for bond sales, commercial paper, tax reporting and the state's trustee function. Mr. Lowrey has previous Department experience as the Chief of Internal Audits for three years and the Chief of Financial Management and Audits for two years. Before Mr. Lowrey's initial tenure with the Department, he worked for the State Controller's Office performing various audit and financial programs. Mr. Lowrey holds a bachelor's degree in accounting from California State Polytechnic University at Pomona, is a Certified Public Accountant and a Certified Governmental Financial Manager.

Eric Tiche
Assistant Deputy Secretary for Bond Finance and Investment since January 2010

Mr. Tiche is responsible for the management and oversight of the Department's debt portfolio, investments and cash management section. Mr. Tiche has been with the Department for more than 11 years. Recent experiences include Manager of the Bond Finance Unit for over two years and Acting Assistant Deputy Secretary, Bond Finance and Investments for one year. His responsibilities include performing and managing all aspects of the Department's financing and investing program. Mr. Tiche graduated from California State University, Sacramento in 1995 with a Bachelor of Science degree in Business Administration (Strategic Management).

George Flores
Loan Processing Operations Manager since May 2007

Mr. Flores has been with the Department of Veterans Affairs for 33 years. He has served as the Manager of the Title and Escrow Unit, Headquarters Operation Manager, Southern Regional Manager, Assistant Division Chief and the Chief of Farm and Home Purchases Division from April 1999 until February 2003. Mr. Flores currently manages the Loan Processing Unit, six District Offices and one satellite office. He is a United States Army veteran who received the Armed Forces Expeditionary Medal. He graduated from California State University, Sacramento, in 1973 with a Bachelor of Science degree in Business Administration, and he attended the McGeorge School of Law, University of the Pacific, Sacramento. He

currently is a member of California Association of Realtors, California Association of Mortgage Professionals, California Building Industry Association and the California Mortgage Bankers Association.

John R. "Jack" Kirwan

Deputy Secretary for Administration since March 2007

Mr. Kirwan was appointed as Deputy Secretary for Administration in March 2007 and has a total of ten years experience with the Department. As Deputy Secretary for Administration he directs a wide range of supportive services through subordinate divisions including the Human Resources, Information Services, Financial Services, and Capital Assets and Facilities Management divisions. Mr. Kirwan retired from the U.S. Navy after serving 25 years on active duty and attaining the rank of Captain. Following graduation from the U.S. Naval Academy in 1973, he was designated a Naval Aviator and served operational tours in west coast fleet helicopter squadrons as well as in the training command as a flight instructor. His shore assignments included duty as an analyst in the Office of the Chief of Naval Operations, advanced education, Naval Reserve staff assignments, and culminated as Commanding Officer of the Naval and Marine Corps Reserve Center in Sacramento. Since his retirement from active duty, Mr. Kirwan has been employed primarily in governmental agencies including as the Chief Business Official for a local school district and most recently with the Department. Mr. Kirwan's previous assignments with the Department were as the Chief of Veterans Services Division and as the Budget Officer.

Robert Wilson

Deputy Secretary and Chief Counsel of Legal Affairs since May 2005

Robert D. Wilson received a Bachelor of Arts degree from the University of Northern Colorado in 1973 with a major in Psychology and a minor in Economics. Following his graduation, he entered the United States Marine Corps and served as a pilot (A-4M). After his discharge from the Corps, he flew commercially for several years. Mr. Wilson then entered law school at the University of Kansas and obtained his J.D. degree in 1988. He has co-authored articles on the good faith obligations imposed upon financial institutions when calling demand notes and judicial jurisdiction over foreign defendants. He practiced law as a litigator in the private sector for approximately eleven years before accepting employment with the Office of the California Attorney General. During his tenure at the Attorney General's Office, Mr. Wilson twice received Attorney General Awards for work on complex prison and governmental law cases.

John Peter "J. P." Tremblay

Deputy Secretary of Communications and Legislation since June 2006

Mr. Tremblay has more than 26 years of experience in the news media, and governmental and political communications. He was appointed as Deputy Secretary for Veterans Affairs by Governor Schwarzenegger in June 2006. Prior to his appointment he was appointed by the Governor as the Assistant Secretary for the Office of Public and Employee Communications for the Department of Corrections and Rehabilitation in July 2005. Mr. Tremblay was appointed Assistant Secretary of the Youth and Adult Correctional Agency in March 1994 by Governor Wilson after serving as his Deputy Director of Communications in 1993. Before joining the Wilson administration, Mr. Tremblay was a political reporter and Capitol Bureau Chief for the Sacramento Union from 1989 to 1993. Before moving to Sacramento, Mr. Tremblay was a

business and government reporter for the Leader Newspaper Group in Los Angeles, California. Mr. Tremblay received his Bachelor of Arts degree from California State University, Northridge.

THE PROGRAM

History

The Department began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the Legislature of the California Veterans Welfare Act of 1921. In 1943, the Legislature enacted the 1943 Act which modified the Program to meet new needs of veterans. The 1943 Act was superseded by the Veterans Farm and Home Purchase Act of 1974 (the “1974 Act”) which again modified the Program. The 1943 Act established the 1943 Fund in the State Treasury, which is the principal fund utilized by the Program.

General

Under the Program, the Department acquires residential property to be sold to eligible veterans under Contracts of Purchase. Generally, a Contract of Purchase creates a land sale contract which is analogous to a loan from the Department to the veteran. See “—Contracts of Purchase – General.” In the discussions pertaining to the Program and Contracts of Purchase which follow, these Contracts of Purchase or land sale arrangements may be referred to as loans.

The description of the Program hereunder is a description of the Program as it currently exists under the Veterans Code and the Department’s implementation thereof. The Veterans Code and the Department’s implementation of the Program are subject to change. The Program is also subject to the Federal Tax Code, as noted below.

Since its inception, the Program has assisted approximately 421,232 veterans to purchase farms and homes throughout the State through long-term farm and housing Contracts of Purchase.

Program Financing

Since its inception, the Program has been financed from the sales of revenue bonds and Veterans G.O. Bonds as well as surplus revenues under the Program not needed at any given time to meet the then-current bond retirement schedules and operating costs. As of March 31, 2010, there were approximately 11,457 Contracts of Purchase outstanding with a remaining principal balance of approximately \$1.604 billion. As of March 31, 2010, the Department had approximately 64 pending applications for Contracts of Purchase in the total principal amount of approximately \$6.62 million. See EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase” and “—Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments” for information regarding existing Contracts of Purchase and moneys available to finance additional Contracts of Purchase.

Certain Statutory Requirements

Certain requirements of the Veterans Code and the Federal Tax Code are discussed below.

Veterans Code

To participate in the Program, an applicant must meet qualifications established under the Veterans Code relating to status as a veteran. The Veterans Code allows the Department to finance Contracts of Purchase for:

(a) veterans who have served, generally, at least ninety consecutive days on active duty in the Armed Forces of the United States, unless sooner discharged because of a service-connected disability, have received an honorable discharge or been released from active duty under honorable conditions and have performed any portion of such service during one of the following periods:

(i) April 6, 1917 through November 11, 1918; December 7, 1941 through December 31, 1946; or June 27, 1950 through January 31, 1955 (such veterans are referred to as “Earlier War Veterans”);

(ii) February 28, 1961 through August 4, 1964 if the veteran served in the Republic of Vietnam during that period; or August 5, 1964 through May 7, 1975 (all veterans referred to in this clause (ii) are “Vietnam Era Veterans”); or

(iii) on or after August 2, 1990, through a date as yet to be determined by the President of the United States; at any time in Somalia, or in direct support of the troops in Somalia, during Operation Restore Hope; or at any time (regardless of the number of days served on active duty) in an expedition or campaign for which a medal was authorized by the United States Government such as the Armed Forces Expeditionary and Vietnam Service Medals (such veterans are referred to as “Recent War Veterans”);

(b) any member of the reserves or National Guard who is called to, and released from, active duty or active service, regardless of the number of days served, during any period when a presidential executive order specifies the United States is engaged in combat or homeland defense, and who received an honorable discharge or was released from active duty or active service under honorable conditions;

(c) any person who has served in the Merchant Marine Service of the United States and has been granted veteran status by the United States Secretary of Defense under Title IV of the GI Improvement Act of 1977 (Public Law 95-202, as amended);

(d) any person who qualifies under the Federal Tax Code for financing from Revenue Bonds or Pre-Ullman Moneys of the Department and who served in the active military, naval or air service for a period of not less than ninety consecutive days and who received an honorable discharge or was released from active duty under honorable conditions (such veterans are referred to as “Peacetime Veterans”); and

(e) any person who qualifies under the Federal Tax Code for financing from Revenue Bonds or Pre-Ullman Moneys of the Department and is at the time of application for benefits a member of the California National Guard or a reserve component of any branch of the United States Armed Forces who has enlisted or been commissioned in that service for a period of not less than six years and has completed a minimum of one year of satisfactory service.

Certain veterans who have served in the current conflicts in Iraq and Afghanistan qualify for participation in the Program under the Veterans Code. The qualifications specified in the Veterans Code are subject to change by the Legislature.

Federal Tax Code

The Federal Tax Code prescribes limitations on the use of moneys from certain sources for the financing of Contracts of Purchase. Such Federal Tax Code limitations reduce the pool of veterans eligible to receive Contracts of Purchase financed from certain sources. See APPENDIX E – “CERTAIN FEDERAL TAX CODE REQUIREMENTS.” Based on the current Federal Tax Code, the Department’s lendable moneys are separated into three classes:

(a) “Pre-Ullman Moneys” (derived from certain moneys in the 1943 Fund, certain proceeds of Pre-Ullman (as defined below) Revenue Bonds and Veterans G.O. Bonds, and certain future issues of taxable bonds, if any), which can finance Contracts of Purchase for those veterans who qualify under the applicable provisions of the Veterans Code. (“Pre-Ullman” refers to the period prior to enactment of Federal Tax Code programmatic restrictions on the use of proceeds of tax-exempt bonds to finance mortgage loans.) The QMB Loan Eligibility Requirements (as defined below) do not apply to Contracts of Purchase financed by Pre-Ullman Moneys. The Department has implemented a policy (which is subject to change) to make Pre-Ullman Moneys available for Earlier War Veterans, Vietnam Era Veterans, Recent War Veterans and Peacetime Veterans.;

(b) “Qualified Veterans’ Mortgage Bond Proceeds” or “QVMB Proceeds” (derived exclusively from proceeds of Veterans G.O. Bonds), which can finance Contracts of Purchase for any veteran who (i) qualifies under the Veterans Code; (ii) served on active duty; and (iii) applied for financing before the day 25 years after the last date on which such veteran left active service. The QMB Loan Eligibility Requirements (as defined below) do not apply to Contracts of Purchase financed by moneys derived exclusively from proceeds of Veterans G.O. Bonds. These proceeds can finance Contracts of Purchase for any veterans; and

(c) “Qualified Mortgage Bond Proceeds” or “QMB Proceeds” (derived principally from Revenue Bond proceeds other than Pre-Ullman Revenue Bond proceeds), which can finance Contracts of Purchase for any veterans who (i) qualify under the Veterans Code and (ii) meet the QMB Loan Eligibility Requirements. “QMB Loan Eligibility Requirements” include, among other things, and subject to certain exceptions contained in the Federal Tax Code, that borrowers (i) either (y) not have had a present ownership interest in their principal residence during the three-year period preceding the date of financing or (z) have not previously received financing of their Contracts of Purchase from the proceeds of Qualified Mortgage Revenue Bonds pursuant to an exception for veterans to the requirement described in (y) (the “First Time Home Buyer Requirement”) or meet certain waiver conditions to the First Time Home Buyer Requirement, (ii) are eligible to finance the purchase of their residence with a purchase price not in excess of limits stated in the Federal Tax Code, (iii) must

not have family incomes in excess of limits stated in the Federal Tax Code, (iv) may not use the proceeds of the financing to refinance an existing mortgage loan and (v) may use the proceeds of the financing solely for the purpose of financing one-family or one-to-four family dwelling units meeting certain criteria.

All financing with respect to targeted area residences and residences on land possessed under certain contract for deed agreements is treated as satisfying the First Time Home Buyer Requirement.

Limits on Purchase Price

Veterans Code

The amount the Department finances is reflected in the Contract of Purchase as the “purchase price.” Under the Veterans Code, the maximum purchase price to the Department of an existing home or the sum to be expended by the Department pursuant to a Contract of Purchase for a home to be constructed may not exceed 125% of the current maximum loan limit for a single-family home, set by Federal National Mortgage Association, commonly known as Fannie Mae (“Fannie Mae”). The Fannie Mae loan limit for a single-family home is \$417,000; therefore, the maximum purchase price to the Department may not exceed \$521,250. Under the Veterans Code, the maximum sum to be expended by the Department pursuant to a Contract of Purchase for a farm may not exceed 150% of the current maximum loan limit set by Fannie Mae. Therefore, the maximum purchase price to the Department for a farm may not exceed \$625,500. Under the Veterans Code, the maximum purchase price to the Department of a mobile home located on or to be located on a leased or rented site in a mobile home park is \$175,000. The maximum purchase price for any home may be increased by an additional \$5,000 for certain purposes.

Federal Tax Code

The Federal Tax Code imposes maximum purchase prices on properties that are the subject of Contracts of Purchase financed by QMB Proceeds and permits such maximums to be adjusted periodically. No Federal Tax Code purchase price limits apply to Contracts of Purchase financed from Pre-Ullman Moneys or QVMB Proceeds. These Federal Tax Code requirements vary depending upon where the property is located, if it is in a targeted or non-targeted area and whether it is a new or existing home.

The maximum purchase price under the Program is, therefore, the maximum amount permitted under the Veterans Code or, if the Contract of Purchase is being financed by QMB Proceeds, the lesser of the maximum amount permitted under the Veterans Code or the maximum amount permitted under applicable provisions of the Federal Tax Code.

Income Limits

Although the Veterans Code does not impose maximum income limits, the Federal Tax Code imposes maximum income limits applicable only to veterans obtaining Contracts of Purchase financed by QMB Proceeds. The income limits vary by statistical area and family size. No maximum income limits apply to veterans obtaining Contracts of Purchase financed by Pre-Ullman Moneys or QVMB Proceeds.

Allocation of Lendable Moneys

For veterans who qualify for Contracts of Purchase from two or more of the financing sources described under “—Certain Statutory Requirements – Federal Tax Code,” above, the Department may select the source of funds to be used in its sole discretion. The Department’s current policy is as follows:

- Contracts of Purchase for all veterans who qualify for financing with QMB Proceeds are funded from QMB Proceeds.
- Contracts of Purchase for all other eligible veterans are funded first from QVMB Proceeds and then Pre-Ullman Moneys.
- Available QMB Proceeds or recycling funds are used to fund Contracts of Purchase for National Guard or reserves members who are only eligible for those funds under State law. See “—Certain Statutory Requirements – Veterans Code.”

The Federal Tax Code includes certain procedures that an issuer of Qualified Mortgage Bonds may undertake to satisfy QMB Loan Eligibility requirements, but requires that 95% or more of the proceeds of each bond issue be used in full compliance with the loan eligibility restrictions.

Administration of the Program

General

Through the Program the Department finances the purchase of new and existing single-family homes, condominiums, certain cooperative housing, farms and mobile homes, and financing of home improvements with respect to properties covered by existing Contracts of Purchase, subject to applicable restrictions. See “—Certain Statutory Requirements.”

Origination

The Department originates Contracts of Purchase through Department staff at its headquarters and field offices and through certain mortgage brokers and mortgage lenders certified by the Department. The Department uses an integrated loan processing and financial information system (“Mitas”) for origination and servicing of all Contracts of Purchase. All Contracts of Purchase are serviced by the Department. See “—Contracts of Purchase - Delinquencies and Cancellations.” The Department is in the process of upgrading the Mitas system to provide enhanced workflow management, document imaging, use of online account information, online payment options and online originations. An origination begins with the collection and evaluation of data regarding the veteran and the property to be acquired under the Contract of Purchase. This evaluation includes an examination of the qualifications of the veteran applying for participation in the Program, a credit analysis of the veteran and the receipt of an appraisal for the applicable property.

If originated outside of the Department’s headquarters, after an initial screening, the application and related data are forwarded to a centralized underwriting unit at the Department’s headquarters for processing. Field offices process certain applications for home improvement and construction financing.

The Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (the “SAFE Act”) was signed into law on July 30, 2008. The SAFE Act is designed to enhance consumer protection and reduce fraud by encouraging states to establish minimum standards for the licensing and registration of loan originators and to establish and maintain the Nationwide Mortgage Licensing System for the residential mortgage industry. The California Department of Corporations began using the Nationwide Mortgage Licensing System starting on January 4, 2010. The Department is in the process of licensing the loan originators on the Department’s staff under the Nationwide Mortgage Licensing System and in compliance with the SAFE Act.

The history of the Department’s originations of Contracts of Purchase is set forth in EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Contracts of Purchase Origination and Principal Repayment Experience.”

Underwriting Credit Analysis

The Department limits availability of financing to veterans on the basis of their personal credit status. The Department’s manual underwriting process is centralized at the Department’s headquarters and is comprised of the following: (i) review credit history, (ii) verify liabilities, (iii) identify and establish sources of verifiable income, (iv) determine housing expenses, including assessment, maintenance, utilities and taxes, (v) determine debt-to-income ratio, (vi) determine amount and source of down payment and (vii) verify assets required for costs to complete the transaction. In evaluating these factors, it is the Department’s policy to decide in favor of the veteran applicant if the Department determines that there is adequate security for the Contract of Purchase. See EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Contracts of Purchase Origination and Principal Repayment Experience.”

Contracts of Purchase with the United States Department of Veterans Affairs (“USDVA”) guarantees require additional documentation in excess of the documents required for other Contracts of Purchase transactions specific to USDVA entitlement and indebtedness. See “—USDVA Guaranty Program; Loan Insurance.”

Subordinate Lending

The Veterans Code permits the Department to finance permanent home and property improvements for veterans with no existing financing or subordinate to existing financing (provided by lenders other than the Department) through the use of a deed of trust as the financing instrument. However, at present the Department does not provide financing for permanent home and property improvements for veterans that is subordinate to existing financing provided by lenders other than the Department. The Department permits the financing of down payments with subordinate financing.

Contracts of Purchase

General

Under a Contract of Purchase, the veteran has the benefits of ownership as the equitable owner of the property, but title to the property and improvements thereon is held by the Department as the legal owner until the final principal payment is made on the Contract of Purchase. Property subject to a Contract of Purchase may not be transferred, assigned,

encumbered, leased, let or sublet without the written consent of the Department. Any such permitted encumbrance must be junior or secondary to the Department's interest in the property.

Variation in Contract of Purchase Terms

The terms of the Contracts of Purchase funded by Pre-Ullman Moneys, QVMB Proceeds or QMB Proceeds are substantially identical except as follows:

- Interest rates on Contracts of Purchase which originated after January 1, 1999 vary. See “—Interest Rates.”
- The Federal Tax Code requires that Contracts of Purchase financed with QMB Proceeds include (a) more restrictions imposed on the right of a purchaser to assume the obligations under the Contract of Purchase than Contracts of Purchase financed by Pre-Ullman Moneys or QVMB Proceeds and (b) certain Federal Tax Code recapture provisions not included in Contracts of Purchase funded from other sources.

See also QMB Loan Eligibility Requirements under “—Certain Statutory Requirements – Federal Tax Code.”

Down Payment Requirements – Term of Contract of Purchase

General

The Veterans Code, in certain cases, requires a veteran obtaining a Contract of Purchase to make an initial payment of at least 2% of either the purchase price or the market value of the property, whichever is less. Department policy requires a veteran obtaining a Contract of Purchase to make an initial payment of at least 3% of the purchase price, unless the veteran obtains a full USDVA guaranty. In either case, the Veterans Code permits the balance of the purchase price to be amortized over a period fixed by the Department not exceeding 40 years. However, pursuant to Department policy, the Department issues all new Contracts of Purchase, except for Contracts of Purchase for mobile homes, for a term of 30 years unless a shorter term is requested. See “—Mobile Homes Contracts of Purchase.”

USDVA Guaranteed Contracts of Purchase

If a veteran obtains a full USDVA guarantee, subject to the Department's underwriting criteria, the Veterans Code permits such veteran to obtain a Contract of Purchase which does not require a down payment. In such cases the purchase price, including USDVA guaranty fees, may be amortized over a period fixed by the Department, not exceeding 30 years and 32 days.

Interest Rates

Pre-January 1999 Contracts of Purchase

Contracts of Purchase originated prior to January 1, 1999 (“pre-1999 Contracts of Purchase”) bear interest at a rate which is set by the Department and may be changed with the approval of the Board and the Veterans' Finance Committee. Most pre-1999 Contracts of Purchase currently bear interest at a rate of 6.95%. The Veterans Code requires that, generally, all pre-1999 Contracts of Purchase bear the same interest rate and that such interest rate can be changed annually as deemed necessary. The effective date of a higher rate of interest on pre-1999 Contracts of Purchase may occur only once in any calendar year unless a finding is made by the Board and the Veterans' Finance Committee that such additional action is necessary to

protect the solvency of the 1943 Fund. See “THE DEPARTMENT – Governance of the Department.”

Post-January 1999 Contracts of Purchase

Contracts of Purchase originated on or after January 1, 1999 (“post-1999 Contracts of Purchase”) are not required to be uniform with respect to interest rates and the Department may modify interest rates applicable to post-1999 Contracts of Purchase and the methodology and timing for determining or modifying interest rates applicable to post-1999 Contracts of Purchase, from time to time, subject to the approval of the Board and the Veterans’ Finance Committee. The interest rates on post-1999 Contracts of Purchase may be adjusted by the Department up to one-half of one percent (0.5%) over the term of the applicable post-1999 Contract of Purchase. The Department has a flexible mechanism to provide for periodic adjustments of the interest rate on new Contracts of Purchase. See “THE DEPARTMENT – Governance of the Department.”

As of May 31, 2010 interest rates for new Contracts of Purchase are as follows:

Interest Rates for New Contracts of Purchase As of May 31, 2010

<u>Interest Rate</u>	<u>Funding Source</u>
5.75%	QMB Proceeds
5.95	QVMB Proceeds
6.20	Pre-Ullman Moneys

Source: Department of Veterans Affairs.

Interest Rate Setting

Interest rates on Contracts of Purchase are expected to be established based on various factors deemed appropriate by the Department, subject in all cases to the requirements of the resolution authorizing the issuance of Revenue Bonds (the “Revenue Bond Resolution”) for the filing of a Cash Flow Statement and conformity with Program Operating Procedures. The Program Operating Procedures are operating policies of the Department governing the discretionary activities of the Department under the Revenue Bond Resolution. The Cash Flow Statement consists of the conclusion by an authorized representative of the Department that projected revenues of the Department will be sufficient to provide for timely payment of principal of and interest on the Revenue Bonds and expenses, under each scenario included in the quantitative analysis which accompanies the Cash Flow Statement. See EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Selected Principal Flows with respect to Contracts of Purchase Funded by both Veterans G.O. Bonds and Revenue Bonds.”

Contract of Purchase Origination Fees

The Department collects an origination fee equal to 1% of the purchase price of the property in addition to any down payment which may be required in connection with a Contract of Purchase. The origination fee is collected at close of escrow on all new Contracts of Purchase and must be paid in escrow. If the Contract of Purchase is originated through an approved mortgage broker or mortgage lender, the origination fee is paid to the mortgage broker or mortgage lender through the escrow. If the Contract of Purchase is originated through the Department, the origination fee is retained by the Department.

Prepayment Penalties

There are no prepayment penalties on any Contracts of Purchase. The Department's actual past prepayment experience for existing Contracts of Purchase is set forth in EXHIBIT 2 to this APPENDIX B – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Contracts of Purchase Origination and Principal Repayment Experience."

Delinquencies and Cancellations

Since 2007, events in the national and global economy and financial markets, including falling home prices, limited credit availability, financial instability, failures of banks and other major financial institutions, a downturn in consumer spending, business bankruptcies, declining real property and investment values and increased job losses, among other factors, have weighed heavily on the global, national and State economies, particularly in the State housing market. Over the past 24 months the Department delinquencies on Contracts of Purchase and the number of cancellations and resulting real estate owned (REOs) have increased.

With respect to USDVA guaranteed Contracts of Purchase, as of March 31, 2010, approximately 3.69% of outstanding number of the Department's Contracts of Purchase were 30 to 60 days delinquent, approximately 4.11% of outstanding number of the Department's Contracts of Purchase were more than 60 days delinquent and approximately 1.73% of outstanding number of the Department's Contracts of Purchase had been added to the REO inventory. As of March 31, 2010, the Department's aggregate delinquency and REO rates (9.53%) exceed the aggregate rates as reported in the March 31, 2010 National Delinquency Survey published by the Mortgage Bankers Association of America (the "Survey"), for USDVA guaranteed loans in California (7.56%), but are less than the aggregate rates, as reported in the Survey, for USDVA guaranteed loans in the United States (9.70%) and the aggregate rates, as reported in the Survey, for prime loans in the United States (10.31%) and California (13.53%). In the Survey loans are categorized as prime loans or otherwise based upon the Survey respondents' internal classifications. See EXHIBIT 2 to this APPENDIX B – "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Cancellations and Delinquencies."

For the nine-month period ended March 31, 2010 and the six fiscal years ended June 30, 2009, the Department experienced approximately \$9.2 million and approximately \$3.2 million, respectively, in loan losses resulting from REO sales and gain or loss on REO sales can be expected to fluctuate based on the market and other considerations during the period that Department bonds are outstanding.

If a veteran fails to comply with any of the terms of a Contract of Purchase the Department may terminate the Contract of Purchase and be released from all obligations thereunder, at law or in equity. In such event, the veteran's rights under the Contract of Purchase may be forfeited and all payments made by the veteran prior to termination of the Contract of Purchase by the Department would be deemed to be rental paid for occupancy of the property by the veteran. In the event the veteran's rights under the Contract of Purchase are forfeited, the Department takes possession of the property for the purposes of reselling it. The Department may, for good cause, permit the postponement from time to time, and upon such terms as it deems proper, of the payment of the whole or any part of any installment.

If a veteran does not make a payment by the 16th day of the month in which the payment is due, the payment is considered “late.” Mitas generates a reminder letter automatically if payment is not received by the 20th day of the month, which advises the veteran that payment has not been received. If payment is not received by the 30th day of the month, a second reminder letter is issued and the Contract of Purchase installment payment is considered “delinquent.” After the second reminder letter is issued the Department’s staff also initiate telephone contact with the veteran. If the Contract of Purchase installment payment remains delinquent 60 days, a Notice of Intent to Cancel Contract (“NICC”) is issued to notify the veteran that the Contract of Purchase may be canceled at the end of the 30-day notice period unless the Contract of Purchase installment payment is brought current. Department personnel continue to initiate telephone contact with veterans with delinquent Contract of Purchase installment payment. If the veteran has not paid by the 70th day of the delinquency, a letter is issued reminding the veteran that he or she must bring the Contract of Purchase installment payment current within 30 days of the NICC date (the “70 Day Reminder Letter”). A schedule for liquidation of delinquent Contract of Purchase installment payments satisfactory to the Department is arranged during this period; however, if the Contract of Purchase installment payment remains delinquent 21 days after the issuance of the 70 Day Reminder Letter and no schedule for liquidation of delinquent installment payments has been agreed upon, the Department may begin cancellation of the Contract of Purchase. If a schedule of liquidation has been agreed to with respect to a Contract of Purchase and the veteran makes all regularly scheduled installment payments and liquidation payments on a timely basis, the Department does not initiate cancellation of the Contract of Purchase.

The Collections, Foreclosure and REO Unit at the Department’s headquarters monitors the delinquency throughout this process, orders a title search to identify any junior lienholders and then commences pre-cancellation processing in accordance with the California Code of Regulations. Junior lienholders are sent notices giving them 30 days (40 days in the case of Federal tax liens) to protect their interest by beginning foreclosure proceedings. If the Contract of Purchase installment payment is not brought current during the 30-day notice period to junior lienholders and no junior lienholder proceeds with a foreclosure action to protect its interest, the Department’s Collections, Foreclosure and REO Unit cancels the Contract of Purchase and a Notice of Cancellation is mailed to the veteran and recorded with the applicable county recorder. The Department’s Foreclosure Unit then takes steps to evict occupants and clear any remaining liens. If judicial action is required, the case is referred to the Department’s Law Division for additional processing.

If a Contract of Purchase guaranteed by the USDVA goes into default, the USDVA has the option of purchasing the related property or paying on the USDVA guarantee. Generally, all of the unpaid principal, accrued interest and foreclosure expenses associated with such Contract of Purchase are recovered from the USDVA if it elects to purchase the related property. If the USDVA does not purchase the related property, the related property becomes Department REO and is sold as such in accordance with the California Code of Regulations. In such cases the USDVA will pay an amount of the veteran’s entitlement toward the unpaid principal, accrued interest and foreclosure expenses within the USDVA-approved limits.

After all remaining liens are removed and the property is vacant, the repossessed property is repaired and improved, if necessary and feasible, and is marketed through the Department’s Collections, Foreclosure and REO Unit which uses a Pre-Advertising Listing (“PAL”) program. Under the PAL program the property is listed for sale with a licensed real estate broker or agent,

at an overall commission rate which typically does not exceed 6%. The Department is required to advertise and accept sealed offers during a 2-week period, after which the property may be sold to the highest acceptable bidder (best net return). If no acceptable bids are received, the property continues to be marketed by the listing real estate agent or broker until an acceptable offer is received and the property is sold. All sales of REO assets are conducted in accordance with the California Code of Regulations.

If a veteran is struggling to make payments on a Contract of Purchase the Department may enter into a repayment agreement (“Repayment Agreement”) with the veteran. Generally, a Repayment Agreement is used to implement a short-term restructuring of the payments under the Contract of Purchase, to accommodate temporary financial difficulties. As of June 30, 2009, the Department had Repayment Agreements in place for approximately 1.51% of the total then outstanding number of Contracts of Purchase (or approximately 2.33% of the then outstanding dollar amount of Contracts of Purchase) and as of March 31, 2010 the Department had Repayment Agreements in place for approximately 1.99% of the total then outstanding number of Contracts of Purchase (or approximately 3.15% of the then outstanding dollar amount of Contracts of Purchase).

Additionally, if a veteran is able to demonstrate financial hardship to the Department, the Department may modify the Contract of Purchase to assist the veteran. Modifications may extend the term of the Contract of Purchase up to a 40 year term for most Contracts of Purchase and up to a 30 year term for a Contract of Purchase financing a mobile home in a mobile home park. When extending the term of the Contract of Purchase the Department reduces the monthly installment payments. In cases where the veteran has already defaulted on the Contract of Purchase at the time of the veteran’s hardship assistance request, the Department may allow the borrower to make reduced payments under a Repayment Agreement for six months. Thereafter, the Department may approve a deferral of the outstanding delinquent interest on the Contract of Purchase. In such cases the delinquent interest is due and payable upon the sale of the property, further encumbrance of the property or upon the maturity of the loan. In some cases the Department may also reamortize the past due principal. As of May 1, 2010, 47 Contracts of Purchase are subject to hardship deferrals.

The Federal Relief Act and the California Relief Act (each as described below) also require certain extensions of Contracts of Purchase terms. See “—Legislative Protection of Veterans” herein. The Department’s policies regarding delinquencies and cancellations conform to USDVA guaranty program requirements and Radian (as defined below) guidelines .

See EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Cancellations and Delinquencies” for additional information regarding the status of Contracts of Purchase.

Late Fees

Late charges are applied to Contracts of Purchase that have a remaining amount due of \$25 or more at the close of any account month. The late charge imposed on Contracts of Purchase originated before October 1984 is \$10. The late charge imposed on Contracts of Purchase originated during and after October 1984 is 4% of the principal and interest portion of the installment, consistent with late charges authorized by the USDVA.

Additional Financing

Any veteran who qualifies under the Veterans Code and the Federal Tax Code may be granted a subsequent Contract of Purchase so long as any previous Contract of Purchase has been paid in full or the veteran lost his or her interest in the previous Contract of Purchase through divorce or dissolution of marriage.

Mobile Homes Contracts of Purchase

The Veterans Code permits the Department to issue Contracts of Purchase for the purchase of mobile homes. If the mobile home is located where the Department obtains title to the land, the Contract of Purchase is treated by the Department in substantially the same manner as Contracts of Purchase to finance the purchase of single family residences. Most commonly such Contracts of Purchase are applicable to mobile homes which are not located in mobile home parks. If the mobile home is located where the Department does not obtain title to the land, the Contract of Purchase is issued by the Department only where the mobile home is in a qualified mobile home park. In such cases the Contract of Purchase is issued with a term of less than thirty years and an interest rate which is 1% higher than the interest rate for Contracts of Purchase issued to finance the purchase of single family residences. Mobile home parks are qualified by Department underwriting staff on a case-by-case basis based on a review of the appraisal, condition of the park, other minimum property standards and the park's rental agreement. The Department also requires the mobile home park management to approve the transaction. As a large percentage of the Department's REO is mobile homes in mobile home parks, the Department revised its policies to limit financing of mobile homes in mobile home parks. New singlewide units may be financed for up to 15 years and a 15% down payment is required. New multi-wide units may be financed for up to 20 years and a 10% down payment is required. Used multi-wide units may be financed the lesser of 20 years or the economic life expectancy of the unit and a 15% down payment is required. No financing is available for used singlewide units or mobile homes which are over 20 years old.

Home Improvement Contracts of Purchase

The Veterans Code permits the Department to finance permanent home and property improvements. Currently, when a home improvement Contract of Purchase issued, the amount of total financing, including the balance of the original Contract of Purchase, the amount of the improvement Contract of Purchase and any other encumbrances, is not permitted to exceed 90% of the improved market value of the property. The Department relies on brokers' informal opinions of value for a determination of the improved market value of the property. Typically the total loan-to-value ratio for a home improvement Contract of Purchase is lower than 90%.

The Department distributes the proceeds from a home improvement Contract of Purchase either to the contractors (or vendors) directly as the improvements are completed or to the veteran as reimbursement for actual construction costs. For a home improvement Contract of Purchase which is subordinate to an existing Contract of Purchase, a separate Contract of Purchase covering only the improvements is executed. The subordinate Contract of Purchase bears interest at the same rate as the veteran's existing Contract of Purchase where the home improvement Contract of Purchase was entered into prior to January 1, 2005, or at current Department rates where the home improvement Contract of Purchase was entered into after January 1, 2005. Home improvement Contracts of Purchase are issued with a term of up to 25 years. Generally, the time of the original Contract of Purchase was entered into through the

pay-off of the home improvement Contract of Purchase does not exceed 40 years. An origination fee of 1.5% of the home improvement Contract of Purchase amount is assessed. Except in the case of hardship, home improvement Contracts of Purchase, generally, are not approved for veterans who have had significant delinquencies in the 12 months immediately preceding the application.

The maximum home improvement Contract of Purchase for veterans funded with QMB Proceeds is \$15,000. Home improvement Contracts of Purchase funded with Pre-Ullman Moneys or QVMB Proceeds are available up to a maximum of \$150,000. Subsequent home improvement Contracts of Purchase may be granted, if funds are available to the Department, so long as there is only one home improvement Contract of Purchase per veteran outstanding at any time. Currently, less than 1% of the total principal balance of all Contracts of Purchase are derived from home improvement Contracts of Purchase.

Construction Contracts of Purchase

Contracts of Purchase entered into to finance the purchase of a building site and construction of a home are also available. Qualifying sites include undeveloped land, lots in subdivision developments and sites in non-profit self-help developments. Mobile homes in parks do not qualify. Construction of the improvements must be performed by a contractor licensed in the State. The Department does not submit Contracts of Purchase that finance home construction for USDVA guaranty (as defined below).

USDVA Guaranty Program; Loan Insurance

Significant principal amounts of Contracts of Purchase in the Department's portfolio are not covered by a USDVA Guaranty (as defined below) or primary mortgage insurance. See "CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase – Current Loan-to-Value Ratio of Contracts of Purchase."

USDVA Guaranty Program. The Servicemen's Readjustment Act of 1944, as amended, permits a veteran (or in certain instances the veteran's spouse) to obtain a guaranty from the USDVA covering mortgage financing for the purchase or construction of certain dwelling units at interest rates permitted by the USDVA (a "USDVA Guaranty"). The USDVA Guaranty Program has no preset mortgage loan limits and permits the guaranty of mortgage loans of up to 30 years and 32 days' duration unless the USDVA, in its sole discretion, approves an extension. Under the USDVA Guaranty Program, the maximum USDVA Guaranty on a loan is an amount equal to 25% of the Freddie Mac conforming loan limit for a single family residence, which is currently \$417,000. The liability on the USDVA Guaranty is reduced or increased *pro rata* with any reduction or increase in the amount of indebtedness, but in no event will the amount payable on the USDVA Guaranty exceed the amount of the original USDVA Guaranty. Notwithstanding the dollar and percentage limitations of the USDVA Guaranty, a mortgage holder will ordinarily suffer a monetary loss only where the difference between the unsatisfied indebtedness and the proceeds of a foreclosure sale of a mortgaged property is greater than the original USDVA Guaranty, as adjusted. Periods without interest payments prior to foreclosure increase the potential for losses. In the event of a default in the payment of a USDVA guaranteed loan, but prior to a suit or foreclosure, USDVA may, at its option, pay to the mortgage holder of such defaulted loan the unpaid balance of the obligation plus accrued interest and receive an assignment of the loan and the security for such loan. For information regarding the amount of

Contracts of Purchase guaranteed by the USDVA, see “—Primary Mortgage Insurance” and “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase – Current Loan-to-Value Ratio of Contracts of Purchase.”

Prior to 1998, Contracts of Purchase were not insured or guaranteed by the USDVA or any private primary mortgage insurer. The Department took steps to reduce Program risk, and as of March 10, 1998, the Department was approved by the USDVA as a “non-supervised lender with automatic processing authority,” which approval allows the Department to underwrite and approve USDVA guaranteed loans without obtaining prior USDVA approval. The Department seeks USDVA Guarantees for all Contracts of Purchase where the veteran qualifies for a USDVA Guaranty; except for Contracts of Purchase for construction, for rehabilitation or for mobile homes in a mobile home park. See “—Primary Mortgage Insurance.”

Generally, for all new Contracts of Purchase with loan-to-value ratios (“LTVs”) in excess of 80%, the Department requires veterans to obtain a USDVA Guaranty; however, the Department does not require veterans to obtain a USDVA Guaranty for Contracts of Purchase for construction, for rehabilitation or for mobile homes in a mobile home park. Since 2002, the Department has obtained, and continues to obtain, USDVA Guarantees on (i) all Contracts of Purchase with LTVs of 97% or greater and (ii) Contracts of Purchase with LTVs in excess of 80% where the veteran qualifies for the USDVA Guaranty. The Department previously provided Radian Guaranty Inc. (“Radian”) primary mortgage insurance for new Contracts of Purchase not guaranteed by the USDVA with LTVs in excess of 80%, but is no longer entering into Contracts of Purchase to be insured by Radian. See “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase – Current Loan-to-Value Ratio of Contracts of Purchase.”

Primary Mortgage Insurance. The Department purchased a policy of primary mortgage insurance from Radian (the “Original Radian Policy”) for a pool of certain then-existing Contracts of Purchase with LTVs exceeding 80% originated before February 1, 1998. Thereafter, the Department purchased an additional policy of primary mortgage insurance from Radian (the “Additional Radian Policy,” and together with the Original Radian Policy, the “Radian Policies”) which provides similar coverage on certain Contracts of Purchase issued after February 1, 1998 as provided in the Original Radian Policy. The Radian Policies provide coverage for aggregate losses incurred on covered Contracts of Purchase following property disposition, above an aggregate 2% deductible based upon a percentage of the originally insured balances of the applicable Contracts of Purchase. As many of the Contracts of Purchase insured under the Original Radian Policy have high originally insured balances but have been paid down significantly over the life of such Contract of Purchases, the Department does not anticipate that it will incur losses on Contracts of Purchase in excess of the 2% deductible. As of December 31, 2009 the aggregate 2% deductible was \$41,672,000 with accumulated total claims to date of \$9,768,000 leaving a difference of \$31,904,000 outstanding. As such, the Department does not expect to collect any amounts under the Radian Policies. Since April 1, 2008 the Department has ceased insuring new Contracts of Purchase with Radian. Instead, where primary mortgage insurance would have been used with respect to a Contract of Purchase the Department has charged the veteran an amount equal to the amount which would have been collected by the Department in respect of a Radian policy, but has retained such payments in a primary mortgage insurance account (the “Primary Mortgage Insurance Account”). As of March 31, 2010 there

was approximately \$5,388,189 in the Primary Mortgage Insurance Account. As of March 31, 2010, the balance of Contracts of Purchase to which the Primary Mortgage Insurance Account applies was approximately \$86,494,000.

The Department is currently in the process of identifying other primary mortgage insurance options to replace Radian, including obtaining Federal Housing Administration guarantees and consideration of reinsuring the Pooled Self-Insurance Fund (as defined below). See “—Pooled Self-Insurance Fund.”

For information regarding the principal amount of Contracts of Purchase covered by the Radian Policies, see “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase – Existing Contracts of Purchase – Current Loan-to-Value Ratio of Contracts of Purchase.”

Funding of USDVA Guaranty or Primary Mortgage Insurance. At the time of origination of each Contract of Purchase the Department collects a funding fee of 1.25% to 3.3% of the Contract of Purchase amount based on the LTV to offset the cost of the USDVA Guaranty or for deposit in the Primary Mortgage Insurance Account. For USDVA guaranteed loans, the funding fee may be added to the purchase price provided it does not exceed the effective maximum loan amount. Veterans obtaining loans described immediately above who are ineligible for a full USDVA Guaranty must have adequate remaining partial USDVA Guaranty entitlement to obtain a 25% USDVA Guaranty (and therefore are obligated to make an initial 3% payment) or must advance a funding fee of up to 3.30% of the base loan amount to the Department at close of escrow, and the funding fee may not be added to the base loan amount. With respect to Contracts of Purchase eligible for a USDVA Guaranty, this fee is paid to the USDVA for the cost of the USDVA Guaranty. If the veteran or the property is not eligible for a USDVA Guaranty, the funding fee is retained by the Department, and a portion of such funding fees is deposited by the Department into the Primary Mortgage Insurance Account. Any change to the foregoing insurance and guaranty expectations may require an amendment to the Department’s Program Operating Procedures and delivery of a new Cash Flow Statement.

Property Insurance

The Veterans Code and long-standing Department policy have both required the veteran contract purchaser to maintain certain insurance with respect to the property covered by a Contract of Purchase. Insurance must be in the amount and under the conditions specified by the Department. In the cases of physical losses, the coverage is provided by the Department up to a specified deductible amount and thereafter by insurance companies selected by the Department under excess coverage insurance policies. Any change to the insurance requirements could require amending the Department’s Program Operating Procedures and delivery of a new Cash Flow Statement. The insurance programs are as follows:

Fire and Hazard Coverage. Under its Fire and Hazard Insurance Program, the Department self-insures fire and hazard losses up to a \$2 million per occurrence deductible and up to a \$10 million annual aggregate deductible from funds collected from the holder of the Contract of Purchase and currently held in an account within the 1943 Fund (the “Fire and Hazard Insurance Account”). In connection with the Pooled Self-Insurance Fund authorized under Assembly Bill 1051, the amounts in the Fire and Hazard Insurance Account will no longer be held within the 1943 Fund, but will be held in the Pooled Self-Insurance Fund. See “—

Pooled Self-Insurance Fund” regarding pooling of certain funds and accounts including amounts in the Fire and Hazard Insurance Account.

A master policy (the “Master Policy”) provides \$20 million coverage in excess of the Department’s self-insured deductibles. The Master Policy does not cover mobile homes, condominiums or planned unit development properties which are already covered by blanket insurance policies maintained by the homeowners’ association. Veterans financing condominiums or planned unit development properties not covered by blanket insurance policies maintained by homeowners’ associations are covered by the Master Policy. Veterans financing mobile homes are required to secure their own coverage. The Master Policy is provided by several commercial insurers. For the Master Policy which was obtained as of October 31, 2009, the lead insurer is Allianz Global Risks US Insurance Company. The Department contracted with Marsh Risk Consulting to conduct a California Wildfire Exposure Analysis in August 2009. The California Wildfire Exposure Analysis concluded that the probable maximum exposure risk to the properties insured under the Program from multiple wildfires in a single year would not exceed \$17.1 million.

The California Wildfire Exposure Analysis and the catastrophe modeling upon which the conclusions in the analysis are based are subject to certain limitations and assumptions including assumptions with respect to inflationary costs, environmental facts, structures, occupancy vulnerability and certain historical loss data. No assurances can be given that the conclusion made in the California Wildfire Exposure Analysis will be accurate.

Under each Contract of Purchase, the veteran is required to pay a sum charged to such veteran’s account to provide amounts required to pay, among other things, (i) a portion of the insurance premium due under the Master Policy, (ii) an amount attributable to the funding of a reserve fund for the Department’s self-insured deductible and (iii) an amount attributable to costs of claims adjusting. Each veteran with a Contract of Purchase pays an annual insurance premium equal to \$0.145 per \$100 of insured value, which is prorated and included in the veteran’s monthly installment. If total losses from a single occurrence exceed \$2 million or if the aggregate of all fire and hazard insurance losses for a policy year exceed \$10 million, the excess will be covered under the Master Policy. The coverage under the Master Policy extends to October 31, 2010. The Master Policy is an all-physical loss form.

Fire and hazard insurance replacement cost coverage for participants in the Program is adjusted annually to reflect increased building costs, and is maintained on a guaranteed replacement cost basis for homes and on an actual cash value basis for outbuildings. A \$250 deductible payable by the veteran applies to each loss and claims must be submitted within 12 months of the loss. Claims adjustments and payments are made on behalf of the Department and processed by Sams and Associates, the claims adjusting company.

The amount in the Fire and Hazard Insurance Account as of March 31, 2010 was approximately \$1,993,436.

Disaster Indemnity Coverage. The Department provides coverage for certain disasters and catastrophes through its disaster indemnity plan and catastrophe real property insurance (“Disaster Indemnity Plan”). Liabilities of the Disaster Indemnity Plan are not payable from (or a part of) the 1943 Fund. The Disaster Indemnity Plan indemnifies participants against the cost of repairing damage caused by flood or earthquake in excess of the following deductibles: \$500 for flood losses and the greater of \$500 or 5% of the amount of loss for earthquake losses. The

catastrophe real property insurance has been obtained from a consortium of seven insurance companies for a total of \$50 million of coverage with a \$4 million deductible per occurrence and in the aggregate annually. The Department has retained 10% of the final \$10 million layer of the catastrophe real property insurance. Once such deductible has been exceeded, subsequent occurrences during the policy year are subject to a \$100,000 per occurrence deductible. The one-year premium for the catastrophe real property insurance starting February 28, 2010 was \$3,847,166.

Each veteran in the Program participates in the Disaster Indemnity Plan and pays his or her *pro rata* share of the annual premium. Such payments are deposited into the Disaster Indemnity Fund created in the Treasury of the State to be utilized to pay the deductible discussed above and the cost for the excess coverage. In connection with the Pooled Self-Insurance Fund authorized under Assembly Bill 1051, the amounts in the Disaster Indemnity Fund will be held in the Pooled Self-Insurance Fund. See “—Pooled Self-Insurance Fund” regarding pooling of certain funds and accounts including amounts in the Disaster Indemnity Fund. Each veteran pays an initial assessment and annual premium of \$.15 per \$100 of insured value, and any assessments as may be required to sustain the Disaster Indemnity Fund. The amount in the Disaster Indemnity Fund as of March 31, 2010 was approximately \$15,925,224.

The Department contracted with Marsh Risk Consulting to conduct an Earthquake Exposure Analysis in August 2009. The Earthquake Exposure Analysis concluded that the expected loss for a 500-year return period is \$110.6 million including the risk of fire after damage following the earthquake event.

The Earthquake Exposure Analysis and the modeling upon which the conclusions in the analysis are based are subject to certain limitations and assumptions including assumptions with respect to inflationary costs, environmental facts, structure construction and values representing replacement cost. No assurances can be given that the conclusions made in the Earthquake Exposure Analysis will be accurate.

Life and Disability Insurance

Prior to 1996, the Department self-insured for life and disability coverage for the holders of Contracts of Purchase from the 1943 Fund. Following a period of significant and recurring losses incurred by the 1943 Fund, in 1996 the Department replaced most of its self-insured life and disability insurance program with an interim life and disability insurance plan. In 1998, the interim plan was replaced with a long-term life insurance and disability plan provided by Pacific Life and Annuity Company (“Pacific Life”). In 2003, the Pacific Life plan was replaced by a five-year life insurance and disability plan provided by Standard Insurance Company which has since been renewed and will expire in January 2013. All holders of Contracts of Purchase who had life and disability coverage (exclusive of those receiving self-insured disability benefits as of the termination date of the self insured plan in 1996) under the insured Pacific Life plan were transferred automatically to the Standard Insurance Company plan. The Department continues to self-insure approximately 70 veterans who were already receiving disability benefits at the time the foregoing life and disability plan was implemented, with benefits equal to the amount of the monthly Contract of Purchase payment at the time of their disability. For those veterans, benefits continue under the provisions of the self-insured plan until the beneficiary returns to active employment or dies, or at the point when the loan balance is fully paid off. Loss reserves for the Department’s self-insured obligations are presently booked and actuarially based. The

Department holds funds in the Legacy Self-Insured Disability Coverage Account in the 1943 Fund (the “Legacy Self-Insured Disability Coverage Account”) to pay all benefits under the self-insured plan. See “SELECTED FINANCIAL DATA OF THE 1943 FUND AND DEPARTMENT’S DISCUSSION.”

In connection with the Pooled Self-Insurance Fund authorized under Assembly Bill 1051, the amounts in the Legacy Self-Insured Disability Coverage account will no longer be held within the 1943 Fund, but will be held in the Pooled Self-Insurance Fund. See “—Pooled Self-Insurance Fund” regarding pooling of certain funds and accounts including amounts in the Legacy Self-Insured Disability Coverage Account.

Notable elements of the life insurance and disability plan include life insurance with a maximum benefit of five-year principal and interest under the mandatory life coverage. Disability coverage, which is now optional, has a 90-day waiting period with a maximum 24-month benefit, unless the injury was the result of an accident, which would allow for a maximum 60-month benefit. The foregoing benefits continue to age 62 for disability and age 70 for life benefit. Additional life, spousal and disability coverage can be purchased by the Contract Holders and billed with their monthly home loan payments.

Pooled Self-Insurance Fund

On October 11, 2009, the Governor signed Assembly Bill 1051 (Chapter 502, Statutes of 2009). Assembly Bill 1051 amended the Veterans Code to permit the creation of a pooled self-insurance fund (the “Pooled Self-Insurance Fund”) to allow the Department to pool certain of its funds and accounts. The Department is in the process of implementing the provisions of Assembly Bill 1051. When implemented, the Pooled Self-Insurance Fund is to be created in the State Treasury and will initially be comprised of moneys of the Department previously on deposit in the Disaster Indemnity Fund, the Fire and Hazard Insurance Account, the Legacy Self-Insured Disability Coverage Account and the Primary Mortgage Insurance Account. Under Assembly Bill 1051, if claims under one Pooled Self-Insurance Fund account exceed funds available in such account, the Department is permitted to borrow from other Pooled Self-Insurance Fund accounts within the Pooled Self-Insurance Fund rather than draw on the 1943 Fund. The Department is also permitted to borrow from the 1943 Fund. Assembly Bill 1051 also requires the Department to manage rates charged to the holders of Contracts of Purchase for each account in the Pooled Self-Insurance Fund, so that each account is self-sufficient. Under Assembly Bill 1051, the Department is permitted to insure or reinsure the risks payable out of the Pooled Self-Insurance Fund.

Legislative Protection of Veterans

Federal law provides certain protections to military personnel on active duty, reservists and members of the National Guard ordered to report for military service under the Servicemembers’ Civil Relief Act of 2003, formerly known as The Soldiers’ and Sailors’ Civil Relief Act of 1940 (the “Federal Relief Act”). Under the Relief Act, a servicemember may seek a stay (or a court may on its own motion grant a stay) of any court action or proceeding. The Relief Act provides that if a servicemember obtained a Contract of Purchase and is later recalled to active duty, then during the period of military service the interest rate on the Contract of Purchase cannot exceed 6% (unless the ability of the servicemember to pay interest in excess of 6% is not materially impaired by such military service). Accordingly, the effect of any

application of the Relief Act in most cases would be a reduction in the applicable interest rate of less than one percent or no reduction at all.

Pursuant to the California Military Families Financial Relief Act (the “California Relief Act”), members of the United States Military Reserves or the California National Guard called to active duty as part of the Iraq and Afghanistan conflicts may defer payments on obligations secured by mortgages and certain other obligations, including Contracts of Purchase, for the lesser of (i) 180 days or (ii) the period of active duty plus 60 calendar days. The California Relief Act requires that reservists desiring to take advantage of such deferments provide notice to their lender and meet certain income requirements. The California Relief Act also requires lenders, such as the Department, to extend the term of loans subject to deferment by the length of the deferral, and prohibits foreclosure or repossession of property during a deferment period.

Under the Program, deferrals required by the California Relief Act are accounted for by the Department through the creation of a deferred balance on the loan account. Any payments on the Contract of Purchase received by the Department in excess of amounts due on such Contract of Purchase are applied to the deferred balance. The Department anticipates that few loans affected by the California Relief Act will be paid in full through regular amortization and that most will be prepaid prior to the end of the term, making an extension of the Contract of Purchase term unnecessary. If a Contract of Purchase affected by the California Relief Act is covered by a USDVA guaranty, the Department will request the USDVA’s approval to extend the loan term, if necessary. To date, the Department has received less than fifty notices from reservists requesting California Relief Act deferrals and there has been no material impact on the 1943 Fund. See “—Contracts of Purchase – Delinquencies and Cancellations” herein.

External Reviews of the Program

The Program and the Department have been the subject of external reviews. The status of the most recent review is briefly explained below.

Bureau of State Audits

The Bureau of State Audits (“BSA”) periodically audits the Department’s USDVA guaranty program as part of the State’s regular Single Audit required under the Single Audit Act of 1984 and the California Government Code. The most recent such audit took place in 2009 which detailed certain deficiencies in electronic reporting under the USDVA’s policies. The Department is working with the USDVA to ensure timely and complete reporting of information in accordance with USDVA’s policies. Additional information regarding BSA audits may be obtained from the BSA at www.bsa.ca.gov. Nothing contained on such website is incorporated into this Official Statement.

USDVA

The USDVA Loan Guaranty Monitoring Unit (the “USDVA Auditors”) periodically audits the Department to determine, among other things, whether the Department is compliant with the laws, regulations and policies governing USDVA guaranties. The most recent audit took place in 2009 and detailed certain deficiencies regarding non-compliance with charges to certain veterans of disallowed fees and charges and circumstances where all property requirements or special conditions required by the appraisal or USDVA were not met prior to requesting the USDVA guaranty. The Department responded to the findings and implemented new procedures in response thereto. The USDVA Auditors have accepted the Department’s

responses as satisfactory and requiring no additional action. Reports of the USDVA Auditors and the Department's responses thereto are available by contacting the Department's Bond Finance Division at P.O. Box 942895, Sacramento, California 94295-0001, telephone (916) 503-8012. Nothing contained in such reports of the USDVA or the Department's response thereto is incorporated into this Official Statement.

THE 1943 FUND

General

The components of the 1943 Fund are (i) proceeds derived from the sale of Revenue Bonds; (ii) proceeds from the sale of Veterans G.O. Bonds; (iii) amounts receivable under all Contracts of Purchase and from sales of properties subject to cancelled Contracts of Purchase; (iv) temporary investments, cash and funds and (v) certain other miscellaneous assets. Proceeds of Veterans G.O. Bonds may not be applied to payment of principal of, and interest or any redemption premium on, the Revenue Bonds. The holders of Veterans G.O. Bonds and Revenue Bonds are not entitled to compel the sale of Contracts of Purchase and the properties to which they relate. Holders of Revenue Bonds are entitled to receive payment out of the Revenues derived from those Contracts of Purchase and properties, subject to the prior claims, if any, of the Veterans G.O. Bonds and of the State for reimbursement of debt service payments made on Veterans G.O. Bonds.

In addition to financing Contracts of Purchase and paying or reimbursing debt service on the Veterans G.O. Bonds and Revenue Bonds, as described below, moneys in the 1943 Fund are used to pay administrative costs of the Department, and to fund certain losses from and reserves for property insurance, mortgages losses and life and disability insurance described in "THE PROGRAM – Property Insurance – Life and Disability Insurance." However, following the implementation by the Department of the Pooled Self-Insurance Fund authorized under Assembly Bill 1051, the amounts in the Fire and Hazard Insurance Account and the Legacy Self-Insured Disability Coverage Account will no longer be held within the 1943 Fund, but will be held in the Pooled Self-Insurance Fund. See "THE PROGRAM - Property Insurance," "—Life and Disability Insurance" and "—Pooled Self-Insurance Fund" regarding pooling of certain funds and accounts including amounts in the Fire and Hazard Insurance Account and the Legacy Self-Insured Disability Coverage Account.

For financial information concerning the 1943 Fund, see EXHIBIT 1 to this APPENDIX B – "FINANCIAL STATEMENTS OF THE 1943 FUND FOR FISCAL YEARS 2009 AND 2008 AND INDEPENDENT AUDITORS' REPORT."

The Veterans' Revenue Debenture Act of 1970, as amended (the "Act") and the Veterans Code provide that the undivided interest created by Resolution RB-1 in favor of the holders of Revenue Bonds in the assets of the 1943 Fund is secondary and subordinate to the interest of the people of the State and the holders of Veterans G.O. Bonds. As described in "AUTHORIZATION OF AND SECURITY FOR THE OFFERED VETERANS G.O. BONDS – Security for and Payment of Veterans G.O. Bonds," moneys in the 1943 Fund must be transferred on the debt service payment dates of Veterans G.O. Bonds, to the Veterans' Bond Payment Fund in the amount of the principal of (whether at maturity or upon redemption), and interest on Veterans G.O. Bonds then due and payable (other than debt service payable from the proceeds of refunding bonds). Debt service on Veterans G.O. Bonds is payable from the General Fund, if the amount transferred to the Veterans' Bond Payment Fund is less than such debt

service amount. Any such shortfall must be transferred to the General Fund out of the 1943 Fund as soon thereafter as it becomes available, together with interest thereon at the rate borne by the applicable Veterans G.O. Bonds, compounded semiannually. Until such amounts are repaid to the General Fund, no payments may be made on the Revenue Bonds other than from amounts then in the Bond Reserve Account and the Loan Loss Account established with respect to the Revenue Bonds. These rights with respect to the 1943 Fund do not grant any lien on the 1943 Fund or the moneys therein to the holders of any Veterans G.O. Bonds.

As of June 15, 2010, there were outstanding approximately \$977,225,000 aggregate principal amount of Veterans G.O. Bonds and commercial paper. Currently, \$1,163,610,000 of new issue Veterans G.O. Bonds are authorized but not issued; such amount does not include the aggregate principal amount of the Offered Veterans G.O. Bonds. As of June 15, 2010, there were approximately \$677,430,000 aggregate principal amount of Revenue Bonds outstanding. Under the Act, Revenue Bonds in an aggregate principal amount not to exceed \$1,500,000,000, at any given time, may be outstanding. The Legislature may increase the amount of Revenue Bonds that can be outstanding under the Act or may decrease such amount to an amount not less than the amount of Revenue Bonds then outstanding. Voters in the State or the Legislature, as applicable, may authorize increases in the amount of issuable Veterans G.O. Bonds. Additional information about outstanding Veterans G.O. Bonds and Revenue Bonds is in EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Veterans G.O. Bonds and Revenue Bonds.”

For additional information regarding the existing interest rates of, and setting interest rates on, Contracts of Purchase, see “—Contracts of Purchase” herein and EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Contracts of Purchase.”

Selected Financial Data of the 1943 Fund and Department’s Discussion

Selected Financial Data of the 1943 Fund

The following table (the “Selected Financial Data”) contains selected financial data of the 1943 Fund for fiscal years ended June 30, 2009 and 2008 which has been derived from the financial statements of the 1943 Fund audited by Deloitte & Touche LLP, independent auditors, whose report thereon appears in EXHIBIT 1 to this Appendix B, and the Department’s accounting records. The Selected Financial Data also contains the comparable financial data of the 1943 Fund for fiscal years ended June 30, 2007, 2006 and 2005, which has been derived from the audited financial statements of the 1943 Fund that are not included herein. **This selected financial data should be read in conjunction with the financial statements and notes thereto of the 1943 Fund contained in said Exhibit 1 and the Department’s Discussion of Financial Data contained herein.**

Non-GAAP Financial Measures

In addition to the results reported in accordance with generally accepted accounting principals for governmental units as presented by the Governmental Accounting Standards Board, as in effect from time to time in the United States (“GAAP”), included in this Appendix B the Department has provided information regarding: net lending and financing activities assets, net insurance activities liabilities, bond interest expense, net interest income (expense), net lending/financing activities income (expense), net administrative activities expense, and net

insurance activities income as calculated and as presented in the Selected Financial Data. These non-GAAP measures, when read in conjunction with the audited financial statements of the 1943 Fund, provide useful information by offering:

- The ability to make more meaningful period-to-period comparisons of the 1943 Fund's on-going operating results;
- the ability to better identify trends in the 1943 Fund's underlying business;
- a better understanding of how the Department plans and measures the 1943 Fund's underlying business; and
- an easier way to compare the 1943 Fund's most recent results of operations against investor and analyst financial models.

Bond interest expense, net interest income (expense), net lending/financing activities income (expense), net administrative activities expense and net insurance activities income should not be considered a substitute or an alternative to these computations (or similar computations) calculated in accordance with and required by GAAP.

SELECTED FINANCIAL DATA OF THE 1943 FUND

(Dollars in Thousands)

	For Six Months Ended on ¹		For Fiscal Years Ended on				
	December 31, 2009	December 31, 2008	June 30, 2009	June 30, 2008	June 30, 2007	June 30, 2006	June 30, 2005
ASSETS AND LIABILITIES RELATED TO LENDING AND FINANCING ACTIVITIES:							
CASH AND INVESTMENTS							
Cash and amounts on Deposit in SMIF	\$ 247,736	\$ 368,886	\$ 286,141	\$ 533,866	\$ 640,905	\$ 446,374	\$ 538,046
Guaranteed Investment Contracts	34,715	25,785	29,776	25,842	30,101	120,356	116,253
	\$ 282,451	\$ 394,671	\$ 315,917	\$ 559,708	\$ 671,006	\$ 566,730	\$ 654,299
DUE FROM VETERANS DEBENTURE							
REVENUE FUND	31,957	31,957	32,089	32,132	32,112	37,765	37,510
OTHER CURRENT ASSETS	11,776	12,278	11,810	13,104	14,705	12,586	11,045
NET OTHER NON-CURRENT ASSETS	4,616	3,663	3,606	3,421	3,849	4,385	3,301
CONTRACTS OF PURCHASE							
Performing Contracts	1,617,017	1,765,858	1,701,943	1,674,651	1,529,993	1,511,853	1,485,528
Non Performing Contracts	34,496	15,079	32,099	12,619	5,193	1,198	2,350
Total	1,651,513	1,780,937	1,734,042	1,687,270	1,535,186	1,513,051	1,487,878
Allowance For Contract Losses	\$ (15,392)	\$ (11,775)	\$ (13,927)	\$ (9,743)	\$ (8,567)	\$ (8,050)	\$ (8,300)
Reduction of REO to Fair Value	(10,917)	(5,010)	(9,103)	(1,994)	(1,055)	(151)	(351)
Total	\$ (26,309)	\$ (16,785)	\$ (23,030)	\$ (11,737)	\$ (9,622)	\$ (8,201)	\$ (8,651)
BONDS PAYABLE							
General Obligation Bonds and Notes	\$ (1,086,300)	\$ (1,273,930)	\$ (1,172,330)	\$ (1,335,095)	\$ (1,335,470)	\$ (1,335,640)	\$ (1,356,315)
Revenue Bonds	(680,255)	(712,240)	(694,805)	(717,010)	(673,235)	(543,360)	(569,075)
Total	\$ (1,766,555)	\$ (1,986,170)	\$ (1,867,135)	\$ (2,052,105)	\$ (2,008,705)	\$ (1,879,000)	\$ (1,925,390)
OTHER CURRENT LIABILITIES	(5,924)	(6,875)	(8,364)	(8,067)	(9,155)	(16,329)	(19,619)
Net Lending & Financing Activities Assets	\$ 183,525	\$ 213,676	\$ 198,935	\$ 223,725	\$ 229,376	\$ 230,987	\$ 240,373
ASSETS AND LIABILITIES RELATED TO INSURANCE ACTIVITIES:							
LIFE AND DISABILITY COVERAGE							
Cash Reserve for Life and Disability	\$ 5,650	\$ 5,497	\$ 5,590	\$ 5,403	\$ 5,324	\$ 5,324	\$ 5,000
Insurance Loss Reserves	(5,498)	(6,987)	(5,490)	(6,761)	(8,881)	(11,408)	(15,000)
Total	\$ 152	\$ (1,490)	\$ 100	\$ (1,358)	\$ (3,557)	\$ (6,084)	\$ (10,000)
FIRE AND HAZARD COVERAGE							
Deposits with Insurance Administrators	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,000	\$ 1,050
Accrued Liabilities	0	0	(428)	(1,504)	(1,173)	(2,600)	(1,591)
Total	\$ 1,000	\$ 1,000	\$ 572	\$ (504)	\$ (173)	\$ (1,600)	\$ (541)
Net Insurance Activities Liabilities	1,152	(490)	672	(1,862)	(3,730)	(7,684)	(10,541)
FUND EQUITY	\$ 184,677	\$ 213,186	\$ 199,607	\$ 221,863	\$ 225,646	\$ 223,303	\$ 229,832
SUMMARY INFORMATION							
Total Assets	\$ 1,963,000	\$ 2,213,000	\$ 2,081,000	\$ 2,290,000	\$ 2,254,000	\$ 2,133,000	\$ 2,191,000
Total Liabilities	\$ 1,778,000	\$ 2,000,000	\$ 1,881,000	\$ 2,068,000	\$ 2,028,000	\$ 1,910,000	\$ 1,961,000
Total Number of Contracts of Purchase	11,819	13,130	12,552	13,299	13,825	14,996	16,470

¹ Derived from unaudited financial statements (which are not included in this Official Statement).

SELECTED FINANCIAL DATA OF THE 1943 FUND
(Dollars in Thousands)

	For Six Months Ended on ¹		For Fiscal Years Ended on				
	December 31, 2009	December 31, 2008	June 30, 2009	June 30, 2008	June 30, 2007	June 30, 2006	June 30, 2005
NET INCOME (EXPENSE) FROM LENDING AND FINANCING ACTIVITIES:							
INTEREST INCOME							
Interest on Contracts	\$ 47,284	\$ 49,656	\$ 99,058	\$ 93,234	\$ 88,424	\$ 84,527	\$ 90,794
Interest on Investments	1,949	7,126	10,783	27,809	30,697	27,900	19,220
Transfers of Interest From Veterans Debtenture Revenue Fund	3,778	609	1,478	1,683	1,713	2,021	2,034
Total	\$ 53,011	\$ 57,391	\$ 111,319	\$ 122,726	\$ 120,834	\$ 114,448	\$ 112,048
BOND INTEREST EXPENSE ²	\$ (44,918)	\$ (52,398)	\$ (101,576)	\$ (106,829)	\$ (105,528)	\$ (110,027)	\$ (111,811)
Net Interest Income (Expense)	\$ 8,093	\$ 4,993	\$ 9,743	\$ 15,897	\$ 15,306	\$ 4,421	\$ 237
AMORTIZATION OF BOND PREMIUM/DISCOUNT	(517)	(575)	(1,467)	(1,382)	(1,113)	(1,407)	(2,219)
Total	\$ (517)	\$ (575)	\$ (1,467)	\$ (1,382)	\$ (1,113)	\$ (1,407)	\$ (2,219)
CONTRACTS OF PURCHASE							
PMI	\$ 0	\$ 0	\$ 0	\$ (833)	\$ (502)	\$ (988)	\$ (1,531)
Net Gain/(Loss) on Sale of REO'S	(5,039)	(980)	(3,468)	(962)	165	204	673
Decrease(Increase) in Allowance for Contract Losses	(3,279)	(5,047)	(11,293)	(2,115)	(1,421)	450	416
Total	\$ (8,318)	\$ (6,027)	\$ (14,761)	\$ (3,910)	\$ (1,758)	\$ (334)	\$ (442)
Net Lending/Financing Activities Income (Expense)	\$ (742)	\$ (1,609)	\$ (6,485)	\$ 10,605	\$ 12,435	\$ 2,680	\$ (2,424)
NET (EXPENSE) FROM ADMINISTRATIVE ACTIVITIES							
Operating Revenues	\$ (5,616)	\$ 608	\$ 1,289	\$ 3,196	\$ 3,507	\$ 5,812	\$ 5,582
Operating Expenses	(7,803)	(7,986)	(18,246)	(16,442)	(15,045)	(20,337)	(21,983)
Net Administrative Activities Expense	\$ (13,419)	\$ (7,378)	\$ (16,957)	\$ (13,246)	\$ (11,538)	\$ (14,525)	\$ (16,401)
NET INCOME (EXPENSE) FROM INSURANCE ACTIVITIES							
Life and Disability Coverage	\$ (2,911)	\$ (895)	\$ (461)	\$ 57	\$ 138	\$ 695	\$ (881)
Fire and Hazard Coverage	2,142	1,205	1,647	(1,200)	1,308	2,321	209
Transfer from Disaster Indemnity	0	0	0	0	0	2,300	0
Net Insurance Activities Income (Expense)	\$ (769)	\$ 310	\$ 1,186	\$ (1,143)	\$ 1,446	\$ 5,316	\$ (672)
TOTAL EXCESS (DEFICIENCY) OF REVENUES AND TRANSFERS OVER EXPENSES	\$ (14,930)	\$ (8,677)	\$ (22,256)	\$ (3,783)	\$ 2,343	\$ (6,529)	\$ (19,497)
FUND EQUITY	\$ 184,677	\$ 213,186	\$ 199,607	\$ 221,863	\$ 225,646	\$ 223,303	\$ 229,832

¹ Derived from unaudited financial statements (which are not included in this Official Statement).

² Excludes amortization of bond premium/discount.

Department's Discussion of Financial Data

Included as part of the financial statements contained in EXHIBIT 1 to APPENDIX B – “FINANCIAL STATEMENTS OF THE 1943 FUND FOR FISCAL YEARS 2009 AND 2008 AND INDEPENDENT AUDITORS’ REPORT” is the section entitled “Management’s Discussion and Analysis of Financial Position and Results of Operations” which presents management’s discussion in relation to the financial statements of the 1943 Fund for the fiscal years ended June 30, 2009 and June 30, 2008 and the changes from prior periods (the “Management Discussion and Analysis”). The Selected Financial Data is presented to provide a summary of the financial position and operations over a longer period of time, and a presentation of the significant changes that have occurred. Certain limited aspects of the Selected Financial Data are discussed below. This discussion should be read in conjunction with the Management Discussion and Analysis and with EXHIBIT 2 to this APPENDIX B – “CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA.”

The Selected Financial Data reflects the changing conditions in the capital market environment in which the Department operates. The California and United States housing and financial markets experienced substantial turmoil as early as 2007. There was a sharp decline in home prices and rising numbers of foreclosures, which led to a decline in the solvency of many financial and corporate firms as well as declines in the availability of credit and global stock prices. There were a significant number of job losses. The national economy continues to face several economic challenges. During the period leading up to 2008, the 1943 Fund experienced a decline in deficiencies of revenues and transfers over expenses and at the end of the fiscal year ended June 30, 2007 the 1943 Fund experienced an excess of revenues and transfers over expenses. The Program, and therefore the financial performance of the 1943 Fund, had benefited from both the improvements in the market environment and the implementation by the Department of strategies to mitigate the impact of adverse market conditions, including an increased emphasis on the quality control of underwriting of Contracts of Purchase and an increase in Department resources for collections and foreclosures. The financial performance of the 1943 Fund improved during the fiscal years ended June 30, 2005 and 2006, with reduced deficiencies of revenues and transfers over expenses of \$19,497,000 and \$6,529,000, respectively. The financial performance of the 1943 Fund demonstrated an excess of revenues and transfers over expenses of \$2,343,000 for the fiscal year ended June 30, 2007 due, in part, to higher interest rates.

During the periods described in the previous paragraph, the Department continued its policy of using repayments of Contracts of Purchase financed with Pre-Ullman Moneys to finance new Contracts of Purchase, rather than using such repayments for the retirement of outstanding Veterans G.O. Bonds and Revenue Bonds. The enactment of the Heroes Earnings Assistance and Relief Tax Act of 2007 (the “HEART Act”) in June 2008 expanded the pool of veterans who are eligible for Contracts of Purchase financed with QVMB Proceeds. Since the enactment of the HEART Act, funds attributable to repayments of Contracts of Purchase financed with Pre-Ullman Moneys have been used for the retirement of outstanding Veterans G.O. Bonds and Revenue Bonds. This has resulted in a reduction of the Department’s cash on deposit in the Surplus Money Investment Fund in the State Treasury (“SMIF”) and has reduced the effect on the 1943 Fund of rates received compared to the rates associated with the retired Veterans G.O. Bonds and Revenue Bonds.

The balance of Veterans G.O. Bonds and Revenue Bonds payable from the 1943 Fund declined to \$1,867,135,000 as of June 30, 2009 from a high of \$2,052,105,000 as of June 30, 2008. This decline included \$76,940,000 of Veterans G.O. Bonds and Revenue Bonds retired from amounts made available during prior periods and the use of repayments of Contracts of Purchase financed with QVMB Proceeds and QMB Proceeds for the retirement of outstanding Veterans G.O. Bonds and Revenue Bonds.

During the period from July 1, 2006 through June 30, 2008, repayments on Contracts of Purchase exceeded new Contract of Purchase originations, resulting in an accumulation of cash, much of which was invested in the SMIF. During this period short-term interest rates generally declined, including the SMIF yields.

During the six-month period ended June 30, 2008, the Department continued to face challenges from declining yields on its funds invested in the SMIF, including funds attributable to repayments of Contracts of Purchase pending the use of such funds for the retirement of outstanding Veterans G.O. Bonds and Revenue Bonds or for the financing of new Contracts of Purchase. For the fiscal year ended June 30, 2008, the average SMIF yield was approximately 4.37%. For the fiscal year ended June 30, 2009, the average SMIF yield had decreased to approximately 2.18%. For the six-month period ended December 31, 2009 the average SMIF yield declined to approximately 0.74%. The declines in the average SMIF yield negatively impacted the Department's interest income. The Department's deposits in the SMIF were \$640,905,000 as of June 30, 2007 and had declined to \$247,736,000 as of December 31, 2009.

As credit policies for the refinancing of loans in the conventional mortgage market tightened in response to the California and United States housing and financial markets turmoil, the Department has not experienced a large number of prepayments of Contracts of Purchase refinanced by conventional mortgages. The balance of Contracts of Purchase held under the 1943 Fund increased for each of the fiscal years described in the Selected Financial Data from \$1,487,878,000 as of June 30, 2005 to \$1,734,042,000 as of June 30, 2009. However, during the six month period ending December 31, 2009, the balance of Contracts of Purchase held under the 1943 Fund declined to \$1,651,513,000 as repayments of Contracts of Purchase continued while the Department originated fewer Contracts of Purchase. Along with the increase in the balance of Contracts of Purchase held under the 1943 Fund through June 30, 2009, the average interest rate on such Contracts of Purchase also increased. For the fiscal year ended June 30, 2008, the average interest rate on outstanding Contracts of Purchase was approximately 5.80%, which increased to approximately 5.90% for the fiscal year ended June 30, 2009. As of March 31, 2010 the average interest rate on outstanding Contracts of Purchase was approximately 5.70%. The decrease is due primarily to the repayment of higher interest rate Contracts of Purchase.

Fiscal Year Ended June 30, 2009

As a result of continuing national financial difficulties, the California housing market and high unemployment rates, during the fiscal year ended June 30, 2009, the financial performance of the 1943 Fund declined and the number of underperforming Contracts of Purchase increased.

Due primarily to the retirement of outstanding Veterans G.O. Bonds and Revenue Bonds, amounts invested in the SMIF and elsewhere decreased from \$559,708,000 as of June 30, 2008 to \$315,917,000 as of June 30, 2009. The SMIF yields during the fiscal year ended June 30, 2009 averaged approximately 2.18%. The fund balance account of the 1943 Fund decreased from \$199,607,000 as of June 30, 2009 to \$184,677,000 as of December 31, 2009. The

percentage of retained earnings of the 1943 Fund in relationship to total assets and total liabilities remained stable from 110.70% at June 30, 2008 to 110.60% as of June 30, 2009. See – “Investments in the Surplus Money Investment Fund,” EXHIBIT 2 to this APPENDIX B – “Certain Department Financial Information and Operating Data – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments” and APPENDIX A – “INVESTMENT OF STATE FUNDS.”

For the fiscal year ended June 30, 2009, net interest income declined but remained positive with a net interest income of \$9,743,000, as compared to \$15,897,000 for the fiscal year ended June 30, 2008. Net Lending/Financing Activities Income also declined, with a net expense of \$6,485,000 for June 30, 2009, as compared to income of \$10,605,000 for June 30, 2008. Total excess of revenues and transfers over expenses decreased correspondingly, with a deficiency of revenues and transfers over expenses of \$22,256,000 for the fiscal year ended June 30, 2009, as compared to a deficiency of \$3,783,000 for the fiscal year ended June 30, 2008.

For the fiscal year ended June 30, 2009, the aggregate principal amount of non-performing Contracts of Purchase increased to \$32,099,000. In the previous three fiscal years, the number of non-performing Contracts of Purchase had increased each year but remained moderate when compared to the rest of the California housing market, due to the Department’s practice of manual underwriting and offering only fixed rate Contracts of Purchase. The Department’s Contracts of Purchase products and underwriting criteria have not changed over the five-year period. The amount of non-performing Contracts of Purchase has increased as the problems in the California housing and job markets have continued. As of fiscal year ended June 30, 2008, the aggregate principal amount of the non-performing Contracts of Purchase was \$12,619,000. With the uncertainty in the California housing market and continued employment uncertainty, there can be no assurances that the number of non-performing Contracts of Purchase will not increase in the future. See “—Recent Market Developments.”

Despite the national financial difficulties, the declines in the California housing markets and high unemployment, certain aspects of the 1943 Fund, including the assets-to-liability ratio and the interest rates on outstanding Contracts of Purchase, remained fairly stable. The principal balance of the Contracts of Purchase held under the 1943 Fund increased by approximately 3% in the fiscal year ended June 30, 2009 due to the origination of new Contracts of Purchase with higher than average loan amounts. The balance of Veterans G.O. Bonds and Revenue Bonds payable from the 1943 Fund decreased to \$1,867,135,000 as of June 30, 2009 from \$2,052,105,000 as of June 30, 2008 due to the Department’s use of cash for the retirement of outstanding Veterans G.O. Bonds and Revenue Bonds. The outstanding balance of non-callable bonds declined to approximately 7% of the outstanding Veterans G.O. Bonds as of June 30, 2009 due to normally scheduled maturity payments.

By executive orders, the Governor directed certain furloughs without pay of State employees beginning on February 1, 2009 and effective through June 30, 2010. As a result, the 1943 Fund realized some reduced expenses. Several lawsuits have been filed against the State challenging such executive orders, including *SEIU v. Schwarzenegger, et al.* (Alameda County Superior Court, Case No. RG-10-516259), in which the plaintiffs allege that the furloughing of State employees of specially funded State entities (i.e., funded from sources other than the General Fund) violates the State Constitution and the plaintiffs seek, among other things, back pay with interest for any furlough dates previously implemented and a halt to any further salary reductions which resulted from the orders. No assurances can be given regarding the outcome of

these matters. See APPENDIX A – “THE STATE OF CALIFORNIA – LITIGATION – Budget Related Litigation – Actions Regarding Furlough of State Employees” for discussion of this case and other related cases.

Stub Period

Despite improvements in the net interest income for the six-month period ended December 31, 2009 (the “Stub Period”), as compared to the six-month period ended December 31, 2008, the financial performance of the 1943 Fund deteriorated during the first half of fiscal year 2010, due to the poor market environment and high unemployment in California. During the Stub Period, the principal balance of the Contracts of Purchase held under the 1943 Fund decreased by approximately 5%.

The balance of Veterans G.O. Bonds and Revenue Bonds payable from the 1943 Fund declined from \$1,986,170,000 as of December 31, 2008 to \$1,766,555,000 as of December 31, 2009 and as of December 31, 2009, the outstanding balance of the non-callable bonds had decreased to represent approximately 4% of the outstanding Veterans G.O. Bonds. The Department expects to make the final maturity payment on the non-callable bonds on October 1, 2010.

Amounts invested in the SMIF and elsewhere decreased from \$394,671,000 as of December 31, 2008 to \$282,451,000 as of December 31, 2009. A material portion of the amounts invested were invested in the SMIF. SMIF investment yields during the Stub Period averaged approximately 0.74% and continued to negatively affect the financial performance of the 1943 Fund. See – “Investments in the Surplus Money Investment Fund,” EXHIBIT 2 to this APPENDIX B – “Certain Department Financial Information and Operating Data – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments” and APPENDIX A – “INVESTMENT OF STATE FUNDS.”

For the Stub Period, net interest income remained positive at \$8,093,000, compared to \$4,993,000 for the six month period ended December 31, 2008. Total excess of revenues and transfers over expenses decreased correspondingly, with a deficiency of revenues and transfers over expenses of \$14,930,000 for the six-month period ended December 31, 2009, as compared to a deficiency of \$8,677,000 for the six-month period ended December 31, 2008. Both the asset and liability accounts of the 1943 Fund declined, resulting in an ending overall asset-to-liability ratio of 110.40% as of December 31, 2009. This amount decreased from 110.60% as of June 30, 2009.

Mitigating Market Factors

The following features of the Program are designed to mitigate and protect the Program from the negative effects of market downturns:

- The Department does not provide variable rate loans.
- The Department requires that, at the time of financing, Program participants reside in the home purchased under the Contracts of Purchase.
- The Department’s underwriting requirements, according to an internal unaudited survey by the Department, have resulted in an average borrower FICO credit score in excess of 700 for transactions originated during the last five years.

- Certain of the Department's Contracts of Purchase are guaranteed through the USDVA guaranty program. See "THE PROGRAM – USDVA Guaranty Program; Loan Insurance."
- Since 2009, all new Contracts of Purchase require a minimum 1.25% funding fee.

The Department cannot predict whether disruptions in the housing and financial markets generally or difficulties in the national or California economies will continue and, if so, whether the Department's finances will be adversely impacted.

Department Outlook

The ability of the Department to return to an excess of revenues over expenses in future periods and the financial performance of the 1943 Fund depends upon a variety of factors including, among others: (a) the level of interest rates available on short-term investments (including the rate paid on the SMIF and investment contracts as such contracts may be acquired) relative to the level of interest rates on outstanding Veterans G.O Bonds and Revenue Bonds; (b) the rate of origination and the rate of prepayment of Contracts of Purchase, which will directly affect the amount of bond proceeds, recycling funds and revenues held in such investments; (c) the interest rates established from time to time by the Department for newly originated Contracts of Purchase relative to the interest cost on bonds issued to finance such Contracts of Purchase; (d) the interest rates on outstanding Contracts of Purchase relative to the interest cost on outstanding bonds; (e) the Department's ability to use special and optional redemption provisions to minimize the overall cost of outstanding debt; (f) the market prices that can be achieved upon the sale of repossessed properties relative to the then-outstanding Contract of Purchase balances; (g) the level of administrative expenses relative to the rate of origination and outstanding balances of the Contracts of Purchase; (h) counter-party performance under the Department's investment agreements; (i) uncertainties, disruption or volatility in the financial markets, generally, and in the mortgage and residential real estate markets, specifically; (j) the accuracy of certain projections and assumptions upon which the Department's financial planning may be based, including, among other things, the rate of repayment of Contracts of Purchase, levels of defaults and delinquencies and losses on Contracts of Purchase; (k) the issuance and structuring of any additional Veterans G.O. Bonds or Revenue Bonds; (l) the implementation of any new programs of the Department; and (m) changes in law, including changes which may affect the timing and the amount the Department may recover from Contracts of Purchase. The Department expects that there will be significant variations in results in future periods, including additional periods in which there may be a deficit of revenues over expenses. Consideration should be given to these factors, among others, in connection with the purchase of the Offered Veterans G.O. Bonds. See "– INTRODUCTION – Forward Looking Statements."

Investments in the Surplus Money Investment Fund

The Department is permitted to participate in the SMIF in an investment portfolio established under the California Government Code, which invests money using the investment expertise of the State Treasurer's Office. The Department invests a material portion of its cash in the SMIF. All investments, including those in the SMIF, contain certain risks, some of which may be material. Such risks include, but are not limited to, a lower rate of return than expected and loss or delayed receipt of principal. These risks may be mitigated, but are not eliminated, by limitations imposed on the portfolio management process by State Treasurer's investment policies, which may change from time to time. See EXHIBIT 2 to this APPENDIX B –

“CERTAIN DEPARTMENT FINANCIAL INFORMATION AND OPERATING DATA – Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments” and APPENDIX A – “INVESTMENT OF STATE FUNDS”.

Excess Revenues

The Department has covenanted with the holders of its Revenue Bonds to apply Revenues received with respect to Contracts of Purchase, after payment or reimbursement of debt service on Veterans G.O. Bonds, in a specified order of priority. The availability and use of Revenues can provide moneys for special redemption of the Offered Veterans G.O. Bonds (see “THE OFFERED VETERANS G.O. BONDS – Redemption – Special Redemption from Excess Revenues). For this purpose, “Revenues” means all moneys received by or on behalf of the Department representing (i) principal and interest payments on the Contracts of Purchase including all prepayments representing the same and all prepayment premiums or penalties received by or on behalf of the Department in respect to the Contracts of Purchase, (ii) interest earnings received on the investment of amounts to the extent deposited in the revenue account established under the Revenue Bond Resolution, (iii) amounts transferred to the revenue account from the bond reserve account or the loan loss amount established under the Revenue Bond Resolution, and (iv) any other amounts payable by parties executing Contracts of Purchase or private participants in the Program or related to recoveries on defaulted Contracts of Purchase, including origination and commitment fees, servicing acquisition fees, liquidation proceeds, and insurance proceeds, *except* to the extent not included as “Revenues” pursuant to the provisions of any resolution authorizing the issuance of a series of Revenue Bonds.

The Department has covenanted with the Revenue Bond holders to administer the 1943 Fund and the Program and perform its obligations to such holders in accordance in all material respects with the then-current Program Operating Procedures. The Program Operating Procedures are operating policies of the Department governing the discretionary activities of the Department under the Revenue Bond Resolution. The Department may amend the Program Operating Procedures. The Program Operating Procedures will affect the Excess Revenues that will become available to redeem the Offered Veterans G.O. Bonds.

The Department has covenanted with the Revenue Bond holders to apply Revenues in the following order, after paying, or reimbursing for payments of, debt service on Veterans G.O. Bonds, including the costs of liquidity and credit enhancement facilities related thereto, and setting aside moneys as required under the Federal Tax Code to preserve the tax-exempt status of certain Veterans G.O. Bonds and Revenue Bonds, (1) to pay debt service on Revenue Bonds, (2) to pay the costs associated with liquidity and credit enhancement facilities, if any, for Revenue Bonds, (3) to replenish certain reserve funds established for the Revenue Bonds, (4) if the Department elects, to pay Department expenses, (5) to set aside a monthly accrual of Veterans G.O. Bond debt service, (6) if the Department elects, to finance Contracts of Purchase, and (7) with respect to Excess Revenues and certain tax restricted moneys, to redeem Veterans G.O. Bonds, including the Offered Veterans G.O. Bonds, and Revenue Bonds. For such purposes:

(a) “Excess Revenues” means, as of any date of calculation, Revenues in excess of Accrued Debt Service;

(b) “Accrued Debt Service” means, as of any date of determination and, as the context requires, with respect to all Revenue Bonds and Veterans G.O. Bonds (including the Offered Veterans G.O. Bonds), the sum of:

(i) the aggregate amount of scheduled interest and principal (except to the extent otherwise to be redeemed pursuant to clause (ii) or (iii) below) to become due after such date but on or before the end of the current debt service year, *less* the product of (x) the number of whole months remaining in the current debt service year and (y) the Monthly Debt Service Requirement;

(ii) the redemption price of bonds for which notice of redemption has been issued, provided such redemption price is to be paid from amounts on deposit in the revenue account created under the Revenue Bond Resolution; and

(iii) the redemption price of bonds that the Department will be obligated to redeem prior to the end of the next succeeding debt service year, to the extent that such obligation arises on account of amounts on deposit in such revenue accounts; and

(c) “Monthly Debt Service Requirements” means, as of any date of determination, one-twelfth of the aggregate amount of scheduled interest and principal to become due during the debt service year in which such date falls, as computed on the first day of such debt service year.

Maintenance of Fund Parity

The Revenue Bond Resolution requires the Department to calculate “Fund Parity” at least annually. “Fund Parity” means (a) an amount equal to the difference between (i) all assets in the 1943 Fund and in the accounts established under the Revenue Bond Resolution, and (ii) the principal amount of all Revenue Bonds and Veterans G.O. Bonds outstanding (plus accrued interest); reduced by (b) defined allowances and reserves for loss coverage on Contracts of Purchase and life and disability coverage on persons obligated under Contracts of Purchase. If any such calculation shall not reflect that Fund Parity at least equals the percentage required by the Revenue Bond Resolution, the Department may be required to expend Excess Revenues to redeem Revenue Bonds until its recalculations of Fund Parity meet the test required by the Revenue Bond Resolution. Currently the applicable required percentage of Fund Parity is 25%. Such applicable percentage has been subject to rating agency confirmation.

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EXHIBIT 1
FINANCIAL STATEMENTS OF THE 1943 FUND
FOR FISCAL YEARS 2009 AND 2008
AND INDEPENDENT AUDITORS' REPORT
VETERANS FARM AND HOME BUILDING FUND OF 1943,
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

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Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs, State of California

Financial Statements for the
Years Ended June 30, 2009 and 2008, and
Independent Auditors' Report

VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

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INDEPENDENT AUDITORS' REPORT

California Veterans Board
State of California
Sacramento, California

We have audited the accompanying balance sheets of the Veterans Farm and Home Building Fund of 1943 (the "Fund"), which is administered by the Department of Veterans Affairs, State of California (the "Department") as of June 30, 2009 and 2008, and the related statements of revenues, expenses, and changes in fund equity and cash flows for the years then ended. These financial statements are the responsibility of the Department's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Fund's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the respective financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such financial statements referred to above present fairly, in all material respects, the financial position of the Veterans Farm and Home Building Fund of 1943, Department of Veterans Affairs, State of California as of June 30, 2009 and 2008, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1, the financial statements present only the Fund, and are not intended to present the financial position of the Department or the results of its operations and cash flows of its proprietary funds.

Management's Discussion and Analysis on pages 2 through 10 is not a required part of the financial statements, but is supplementary information required by the *Governmental Accounting Standards Board*. This supplementary information is the responsibility of the Department's management. We have applied certain limited procedures, which consisted primarily of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and we do not express an opinion on it.

Deloitte & Touche LLP

October 14, 2009

VETERANS FARM AND HOME BUILDING FUND OF 1943

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL POSITION AND RESULTS OF OPERATIONS FOR THE YEARS ENDED JUNE 30, 2009 AND 2008

Introduction – The Department of Veterans Affairs

The Department of Veterans Affairs (the “Department”) began making low interest rate farm and home financing available to veterans after World War I, following the enactment by the California Legislature of the Veterans Farm and Home Purchase Act of 1921 (the “Cal-Vet Farm and Home Program” or the “Program”). In 1943, the Legislature enacted the Veterans Farm and Home Purchase Act of 1943 which modified the Program to meet new needs of California’s veterans. The 1943 Act established the 1943 Fund in the State Treasury and the Department established the Veterans Farm and Home Building Fund of 1943 (the “Fund”), which is the principal fund utilized for the Cal-Vet Farm and Home Loan Program. Financing is provided as installment loans, which are referred to as Contracts of Purchase.

The sales of the Fund’s Home Purchase Revenue Bonds and Veterans General Obligations Bonds combined with monies received from prepayments of Contracts of Purchase and other revenues under the Program not needed at any given time to meet the then current bond retirement schedules and operating costs have financed the purchase of farms and homes since the Program’s inception. Expenditures are primarily for debt service and administration of the Program.

Fiscal Year 2009 Compared to Fiscal Year 2008

Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of June 30, 2009 and June 30, 2008 (dollars in thousands) and the percentage change.

	2009	2008	Change	% Change
ASSETS				
Cash, cash equivalents and investments	\$ 322,507	\$ 566,111	\$ (243,604)	(43.0)%
Receivables under contracts of purchase—net	1,688,016	1,664,908	23,108	1.4 %
Other receivables and assets	<u>70,501</u>	<u>59,282</u>	<u>11,219</u>	18.9 %
TOTAL ASSETS	<u>\$ 2,081,024</u>	<u>\$ 2,290,301</u>	<u>\$ (209,277)</u>	(9.1)%
LIABILITIES AND FUND EQUITY				
Liabilities:				
Bonds payable	\$ 1,852,512	\$ 2,035,092	\$ (182,580)	(9.0)%
Other payables and liabilities	<u>28,905</u>	<u>33,346</u>	<u>(4,441)</u>	(13.3)%
Total liabilities	1,881,417	2,068,438	(187,021)	(9.0)%
Fund Equity	<u>199,607</u>	<u>221,863</u>	<u>(22,256)</u>	(10.0)%
TOTAL LIABILITIES AND FUND EQUITY	<u>\$ 2,081,024</u>	<u>\$ 2,290,301</u>	<u>\$ (209,277)</u>	(9.1)%

Assets

Total assets decreased by \$209.3 million from \$2.290 billion at June 30, 2008 to \$2.081 billion at June 30, 2009. This decrease consisted primarily of the following items:

- Total cash, cash equivalents and investments decreased by \$244 million from \$566 million at June 30, 2008 to \$322 million at June 30, 2009. The decrease is a principally due to excess proceeds bond calls and significantly lower interest on investments.
- Net receivables under contracts of purchase increased by \$23.1 million from \$1.665 billion at June 30, 2008 to \$1.688 billion at June 30, 2009. The change was due to new contracts with larger loan amounts than average in the portfolio.
- All other receivables and assets increased by \$11.2 million from \$59.3 million at June 30, 2008 to \$70.5 million at June 30, 2009.

Liabilities and Fund Equity

Total liabilities decreased by \$187 million from \$2.068 billion at June 30, 2008 to \$1.881 billion at June 30, 2009, principally due to excess proceeds bond calls.

Fund equity decreased by \$22.3 million from \$221.9 million at June 30, 2008 to \$199.6 million at June 30, 2009, as a result of unfavorable holding costs of cash assets, less revenue due to fewer loans processed and increased reserves for future REO losses.

The total assets to liability ratio remained unchanged at 1.11 as of June 30, 2009 and June 30, 2008.

Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended June 30, 2009 and June 30, 2008 (dollars in thousands) and the percentage change.

	2009	2008	Change	% Change
PROGRAM OPERATIONS:				
Interest revenues:				
Contracts of purchase	\$ 99,058	\$ 93,234	\$ 5,824	6.2 %
Investments and other	<u>12,261</u>	<u>29,492</u>	<u>(17,231)</u>	(58.4)%
Total program operating revenues	111,319	122,726	(11,407)	(9.3)%
Expenses:				
Interest expense	103,043	108,211	(5,168)	(4.8)%
Change in allowance for uncollectible contracts	<u>11,293</u>	<u>2,115</u>	<u>9,178</u>	433.9 %
Total program operating expenses	<u>114,336</u>	<u>110,326</u>	<u>4,010</u>	3.6 %
Excess of program operations revenues over program operations expenses	<u>(3,017)</u>	<u>12,400</u>	<u>(15,417)</u>	(124.3)%
PROGRAM ADMINISTRATION:				
Total program administration revenues	2,475	2,053	422	20.6 %
Total program administration expenses	<u>18,246</u>	<u>17,274</u>	<u>972</u>	5.6 %
Excess of program administration expenses over program administration revenues	<u>(15,771)</u>	<u>(15,221)</u>	<u>(550)</u>	3.6 %
Operations excess (deficiency) of revenues over (under) expenses	(18,788)	(2,821)	(15,967)	566.0 %
(Loss) gain on sale of repossessed property	<u>(3,468)</u>	<u>(962)</u>	<u>(2,506)</u>	260.5 %
(Deficiency) excess of revenues (under) over expenses	<u>\$ (22,256)</u>	<u>\$ (3,783)</u>	<u>\$ (18,473)</u>	488.3 %

Program Operations

Program operations revenues in excess of program operations expenses decreased \$15.4 million from \$12.4 compared to a deficiency of \$3.0 million for the fiscal year ended June 30, 2008 and 2009, respectively, due to the following:

- Interest revenue from contracts of purchase increased by \$5.8 million from \$93.2 million for the year ended June 30, 2008 to \$99.1 million for the year ended June 30, 2009, due to the replacement of lower rate contracts with new contracts with larger loan amounts at higher interest rates.
- Interest revenues on investments decreased by \$17.2 million from \$29.5 million for the year ended June 30, 2008 to \$12.3 million for the year ended June 30, 2009. This decrease is due to the SMIF quarterly interest rate decreasing over the fiscal year from 3.11% at June 30, 2008 to 1.51% at June 30, 2009 combined with a decrease in the cash, cash equivalents and investments during that time.
- Net program operation expenses increased \$4.0 million from \$110.3 the year ended June 30, 2008 to \$114.3 million for the year ended June 30, 2009. The increase is due to a decrease of \$5.2 million in interest expense related to a decrease in bonds outstanding and a \$9.2 million increase in the allowance for uncollectible contracts of purchase.

Program Administration

Total program administration revenues include loan origination fees paid to the Department, loan guarantee fees collected by the Department to be applied, in part, to the purchase of private mortgage insurance and premiums collected by the department for the fire and hazard insurance program. Total program administration revenues increased by \$0.4 million from \$2.1 million for the year ended June 30, 2008 to \$2.5 million for the year ended June 30, 2009, due to the following:

- The fire and hazard insurance program experienced an increase in net revenues of \$2.8 million due to fewer claimed losses during the fiscal year.
- Other income decreased by \$1.6 million, offset by a decrease of \$0.8 million related to loan origination fees.

Total program administration expenses increased by \$1.0 million from \$17.3 million for the year ended June 30, 2008 to \$18.3 million for the year ended June 30, 2009. The increase is due to an increase of payroll and other support expenditures related to the increase of staff and expenses related to work on delinquencies and REO's.

The sale of repossessed properties resulted in a loss of \$3.5 million for the year ended June 30, 2009 compared to a loss of \$1.0 million for the year ended June 30, 2008 due to a reduction in property values from loans made in the calendar years 2005, 2006 and 2007. The Funds' holdings of repossessed properties, net of allowances for losses increased from \$10.6 million as of June 30, 2008 to \$23.0 million as of June 30, 2009.

OVERVIEW OF LOAN PORTFOLIO

Single Family Home Loans

The Department makes loans to veterans for the purchase of individual residences. Approximately 99.9% of the dollar volume of the Department's loans are for home loans as of June 30, 2009. Currently the maximum loan amount is \$521,250 which represents 125% of the maximum loan limit for a single-family home set by the Federal National Mortgage Association ("Fannie Mae").

Loans are made after an underwriting process that includes, but is not limited to: a review of credit history, verifiable income and the amount and source of down payment. In general credit scores of approved applicants are above the average. Loans with an initial loan to value ("LTV") of greater than 80% are required to be insured, either through private mortgage insurance or through the guarantee program of the United States Department of Veterans Affairs (USDVA). Loans with a LTV of 97% or greater are required to be insured through the USDVA guaranty program. Under the USDVA guarantee program, the Department is insured for the first 25% of loss in the event that they are required to foreclose on a property and need to sell that property for less than the outstanding loan balance.

Interest rates for loans are determined when the loan is originated. As of June 30, 2009, interest rates on loans outstanding ranged from 9.75% to 4.25%. While the Department has the limited ability to adjust the interest rates, post-1999 loans can be adjusted by 0.5% if needed and pre-1999 loans can be adjusted with no rate cap, the policy of the Department has been to leave the interest rate fixed at the rate in effect when the loan was originated.

Mobile Homes

The Department makes loans to veterans for the purchase of mobile homes. Approximately 7% of the dollar volume of the Department's loans are for home loans as of June 30, 2009. Currently the maximum loan amount is \$175,000. The terms of the loans for mobile homes are substantially the same as loans made to finance the purchase of single family homes. In certain circumstances the interest rate of a mobile home loan may be 1% higher than an equivalent loan on a single family home.

Construction or Home Improvement Loans

The Department makes a limited amount of construction or home improvement loans. These loans typically have a LTV of lower than 90%. The Department did not have a significant amount of construction or home improvement loans outstanding at June 30, 2009.

ALLOWANCES FOR UNCOLLECTIBLE LOANS AND LOSSES ON OTHER REAL ESTATE OWNED

The allowance for uncollectible contracts is established through a provision charged to operations. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectability and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers' ability to repay the obligation. Management updates its estimates periodically to take into account changes in the economic environment. The allowance for uncollectible contracts was \$13,927,000 and \$9,743,000 as of June 30, 2009 and 2008, respectively.

Other Real Estate Owned — Real estate acquired by the Fund by repossession is recorded at the lower of estimated fair value less estimated selling costs (fair value) or the carrying value of the related loan at the date of foreclosure. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses. Operating costs on foreclosed real estate are expensed as incurred. Costs incurred for physical improvements to foreclosed real estate are capitalized if the value is recoverable through future sale.

Higher-Risk Loans

The Departments higher risk loans, designated by having a loan-to-value ratio of 97% or greater, are evenly dispersed throughout the state. The loan to value ratio was determined by dividing the current loan balance by the initial purchase price of the property. Out of our 11,763 loan portfolio (not including Home Improvement Loans) only 7.8% of those loans were determined to have a high loan-to-value ratio. The highest concentration of those loans was in San Diego County with these loans representing less than 1% of the Department's total portfolio. Reducing the risk of many of the loans in the portfolio is the fact that 98% of the high loan-to-value loans in the Department's portfolio are currently insured with USDVA leaving only 0.16% of the total portfolio being uninsured and having a high loan-to-value ratio.

Changes in Practices

Due to the current economic market norms and the high percentage of Mobil Home REO's, the Department has revised its Mobile Home policy to include the following provisions:

- New Singlewide units may be financed for up to a maximum term of 15 years
 - Required down payment amount is 15%
- Used Singlewide units – no financing available
- New Multiwide units may be financed for up to a maximum term of 20 years
 - Required down payment amount is 10%
- Used Multiwide units may be financed for up to a maximum term of 20 years or the economic life expectancy, whichever is less.
 - Required down payment amount is 15%
- CalVet will not finance mobile homes that are over 20 years old

Economic Factors Facing Veterans Farm & Home Building Fund of 1943

At June 30, 2009, the Program's loan portfolio balance was at approximately \$1.688 billion, an increase of \$23 million, or 1.4%, from \$1.665 billion at June 30, 2008. During the fiscal year, cash and investments balance decreased \$244 million, or 43.0%, from a balance of \$566 million to \$322 million. Bonds payable decreased \$183 million, or 9.0%, from \$2.035 billion at June 30, 2008 to \$1.852 billion at June 30, 2009. Bond ratings for the Department's GO bonds are AA-, A1 and A+ by rating agencies Standard & Poor's, Moody's and Fitch, respectively. Bond ratings for the Department's Revenue bonds are AA-, Aa2 and AA- by Standard & Poor's, Moody's and Fitch, respectively.

The passage of the HR6081 *Heroes Earnings Assistance and Relief Tax Act of 2008* and HR3221 *Housing and Economic Recovery Act of 2008* has dramatically increased the number of veterans eligible to apply to CalVet for housing loans and makes future bond issues exempt from the alternative minimum tax calculation.

Fiscal Year 2008 Compared to Fiscal Year 2007

Condensed Balance Sheets

The following table presents condensed balance sheets for the Fund as of June 30, 2008 and June 30, 2007 (dollars in thousands) and the percentage change.

	2008	2007	Change	% Change
ASSETS				
Cash, cash equivalents and investments	\$ 566,111	\$ 677,330	\$ (111,219)	(16.4)%
Receivables under contracts of purchase—net	1,664,908	1,521,426	143,482	9.4 %
Other receivables and assets	<u>59,282</u>	<u>54,804</u>	<u>4,478</u>	8.2 %
TOTAL ASSETS	<u>\$ 2,290,301</u>	<u>\$ 2,253,560</u>	<u>\$ 36,741</u>	1.6 %
LIABILITIES AND FUND EQUITY				
Liabilities:				
Bonds payable	\$ 2,035,092	\$ 1,992,718	\$ 42,374	2.1 %
Other payables and liabilities	<u>33,346</u>	<u>35,196</u>	<u>(1,850)</u>	(5.3)%
Total liabilities	2,068,438	2,027,914	40,524	2.0 %
Fund Equity	<u>221,863</u>	<u>225,646</u>	<u>(3,783)</u>	(1.7)%
TOTAL LIABILITIES AND FUND EQUITY	<u>\$ 2,290,301</u>	<u>\$ 2,253,560</u>	<u>\$ 36,741</u>	1.6 %

Assets

Total assets increased by \$36.7 million from \$2.254 billion at June 30, 2007 to \$2.290 billion at June 30, 2008. This increase consisted primarily of the following items:

- Total cash, cash equivalents and investments decreased by \$111 million from \$677 million at June 30, 2007 to \$566 million at June 30, 2008. The decrease is a direct result of an increase in the loan portfolio.
- Net receivables under contracts of purchase increased by \$143.4 million from \$1.521 billion at June 30, 2007 to \$1.665 billion at June 30, 2008. The change was due to higher interest rates and tightened credit standards in the general housing market, which made the Program's loans more attractive to veterans, causing an increase in loan originations and reduced prepayments. while high property values in California resulted in larger individual loans.
- All other receivables and assets increased by \$4.5 million from \$54.8 million at June 30, 2007 to \$59.3 million at June 30, 2008.

Liabilities and Fund Equity

Total liabilities increased by \$41 million from \$2.028 billion at June 30, 2007 to \$2.069 billion at June 30, 2008, principally due to the issuance of bonds in current fiscal year.

Fund equity decreased by \$3.8 million from \$225.6 million at June 30, 2007 to \$221.8 million at June 30, 2008, as a result of the excess of expenses over revenue.

The total assets to liability ratio remained unchanged at 1.11 as of June 30, 2008 and June 30, 2007.

Condensed Statements of Revenues and Expenses

The following table presents condensed statements of revenues and expenses for the Fund for the fiscal years ended June 30, 2008 and June 30, 2007 (dollars in thousands) and the percentage change.

	2008	2007	Change	% Change
PROGRAM OPERATIONS:				
Interest revenues:				
Contracts of purchase	\$ 93,234	\$ 88,424	\$ 4,810	5.4 %
Investments and other	<u>29,492</u>	<u>32,410</u>	<u>(2,918)</u>	(9.0)%
Total program operating revenues	122,726	120,834	1,892	1.6 %
Expenses:				
Interest expense	108,211	106,641	1,570	1.5 %
Change in allowance for uncollectible contracts	<u>2,115</u>	<u>1,421</u>	<u>694</u>	48.8 %
Total program operating expenses	<u>110,326</u>	<u>108,062</u>	<u>2,264</u>	2.1 %
Excess of program operations revenues over program operations expenses	<u>12,400</u>	<u>12,772</u>	<u>(372)</u>	(2.9)%
PROGRAM ADMINISTRATION:				
Total program administration revenues	2,053	4,953	(2,900)	(58.6)%
Total program administration expenses	<u>17,274</u>	<u>15,547</u>	<u>1,727</u>	11.1 %
Excess of program administration expenses over program administration revenues	<u>(15,221)</u>	<u>(10,594)</u>	<u>(4,627)</u>	43.7 %
Operations excess (deficiency) of revenues over (under) expenses	(2,821)	2,178	(4,999)	(229.5)%
(Loss) gain on sale of repossessed property	<u>(962)</u>	<u>165</u>	<u>(1,127)</u>	(683.0)%
(Deficiency) excess of revenues (under) over expenses	<u>\$ (3,783)</u>	<u>\$ 2,343</u>	<u>\$ (6,126)</u>	(261.5)%

Program Operations

Program operations revenues in excess of program operations expenses decreased \$0.4 million from \$12.8 compared to \$12.4 million for the fiscal year ended June 30, 2007 and 2008, respectively, due to the following:

- Interest revenue from contracts of purchase increased by \$4.8 million from \$88.4 million for the year ended June 30, 2007 to \$93.2 million for the year ended June 30, 2008, due to the replacement of lower rate contracts with new contracts with larger loan amounts at higher interest rates.
- Interest revenues on investments decreased by \$2.9 million from \$32.4 million for the year ended June 30, 2007 to \$29.5 million for the year ended June 30, 2008. This decrease is due to the SMIF quarterly interest rate decreasing over the fiscal year from 5.24% at June 30, 2007 to 3.11% at June 30, 2008 combined with a decrease in the cash, cash equivalents and investments during that time.
- Net program operation expenses increased \$2.3 million from \$108.0 the year ended June 30, 2007 to \$110.3 million for the year ended June 30, 2008. The increase is due to an increase of \$1.5 in interest expense related to an increase in bonds outstanding and a \$.7 million increase in the allowance for uncollectible contracts of purchase.

Program Administration

Total program administration revenues include loan origination fees paid to the Department, loan guarantee fees collected by the Department to be applied, in part, to the purchase of private mortgage insurance and premiums collected by the department for the fire and hazard insurance program. Total program administration revenues decreased by \$2.8 million from \$4.9 million for the year ended June 30, 2007 to \$2.1 million for the year ended June 30, 2008, due to the following:

- The fire and hazard insurance program experienced a net increase in costs of \$2.5 million related to the California wildfires
- Other income decreased by \$0.8 million, offset by an increase of \$0.5 million related to loan origination fees.

Total program administration expenses increased by \$1.7 million from \$15.6 million for the year ended June 30, 2007 to \$17.3 million for the year ended June 30, 2008. The increase is due to an increase of payroll and other support expenditures related to the passage of HR6081 *Heroes Earnings Assistance and Relief Tax Act of 2008* and HR3221 *Housing and Economic Recovery Act of 2008* (the “Legislation”).

The sale of repossessed properties resulted in a loss of \$1.0 million for the year ended June 30, 2008 compared to a gain of \$.2 million for the year ended June 30, 2007 due to a reduction in property values from loans made in the calendar years 2005 and 2006. The Funds’ holdings of repossessed properties, net of allowances for losses increased from \$4.1 million as of June 30, 2007 to \$10.6 million as of June 30, 2008.

VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

BALANCE SHEETS

JUNE 30, 2009 AND 2008 (In thousands)

	2009	2008
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents:		
Cash in State Treasury	\$ 19,590	\$ 15,178
State of California's Surplus Money Investment Fund	266,551	518,688
Total cash and cash equivalents	286,141	533,866
Current portion of receivables under contracts of purchase — net of allowance for uncollectible contracts	46,923	49,133
Interest receivables:		
Contracts of purchase	10,557	8,712
State of California's Surplus Money Investment Fund	1,122	4,267
Other investments	131	125
Total interest receivables	11,810	13,104
Total current assets	344,874	596,103
NONCURRENT ASSETS:		
Investments:		
Guaranteed investment contracts	29,776	25,842
Insurance administrators	6,590	6,403
Total investments	36,366	32,245
Receivables under contracts of purchase — net of allowance for uncollectible contracts	1,641,093	1,615,775
Due from Veterans Debenture Revenue Fund	32,089	32,132
Other real estate owned — net of allowance for losses of \$9,103 and \$1,994, respectively	22,996	10,625
Land, improvements, and equipment — net of accumulated depreciation of \$15,761 and \$15,723, respectively	532	570
Other noncurrent assets	3,074	2,851
Total noncurrent assets	1,736,150	1,694,198
TOTAL	\$2,081,024	\$2,290,301
LIABILITIES AND FUND EQUITY		
CURRENT LIABILITIES:		
Bonds payable — current portion	\$ 67,025	\$ 97,015
Accrued interest and other liabilities	22,654	24,171
Due (to) from other funds	(148)	586
Fire and hazard insurance claims payable	428	1,504
Total current liabilities	89,959	123,276
NONCURRENT LIABILITIES:		
Bonds payable — noncurrent portion	1,785,487	1,938,077
Other postemployment benefits	481	324
Self-insured life and disability insurance loss reserve	5,490	6,761
Total noncurrent liabilities	1,791,458	1,945,162
Total liabilities	1,881,417	2,068,438
COMMITMENTS AND CONTINGENCIES (Note 9)		
FUND EQUITY — Unrestricted	199,607	221,863
TOTAL	\$2,081,024	\$2,290,301

See notes to financial statements.

**VETERANS FARM AND HOME BUILDING FUND OF 1943,
DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA**

**STATEMENTS OF REVENUES, EXPENSES, AND CHANGES IN FUND EQUITY
YEARS ENDED JUNE 30, 2009 AND 2008 (In thousands)**

	2009	2008
PROGRAM OPERATIONS:		
Interest revenues:		
Contracts of purchase of properties	\$ 99,058	\$ 93,234
Investments and other	10,783	27,809
Transfers of revenues from Veterans Debenture Revenue Fund	<u>1,478</u>	<u>1,683</u>
Total program operations revenues	<u>111,319</u>	<u>122,726</u>
Expenses:		
Interest expense	103,043	108,211
Change in allowance for uncollectible contracts	<u>11,293</u>	<u>2,115</u>
Total program operations expenses	<u>114,336</u>	<u>110,326</u>
(Deficiency) excess of program operations revenue (under) over program operations expenses	<u>(3,017)</u>	<u>12,400</u>
PROGRAM ADMINISTRATION:		
Revenues:		
Loan fees	2,158	2,932
Other (expense) income	(869)	264
Net revenue (expense) — fire and hazard insurance program	1,647	(1,200)
Net (expense) revenue — self-insured life and disability insurance program	<u>(461)</u>	<u>57</u>
Total program administration revenues	<u>2,475</u>	<u>2,053</u>
Expenses:		
Payroll and related costs	9,732	9,703
General and administrative expenses	<u>8,514</u>	<u>7,571</u>
Total program administration expenses	<u>18,246</u>	<u>17,274</u>
Deficiency of program administration revenues under program administration expenses	<u>(15,771)</u>	<u>(15,221)</u>
OPERATIONS DEFICIENCY OF REVENUES UNDER EXPENSES	(18,788)	(2,821)
NONOPERATING REVENUE — Loss on sale of repossessed property	<u>(3,468)</u>	<u>(962)</u>
Deficiency of revenues under expenses	(22,256)	(3,783)
FUND EQUITY:		
Beginning of year	<u>221,863</u>	<u>225,646</u>
End of year	<u>\$ 199,607</u>	<u>\$ 221,863</u>

See notes to financial statements.

VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

STATEMENTS OF CASH FLOWS

YEARS ENDED JUNE 30, 2009 AND 2008 (In thousands)

	2009	2008
CASH FLOWS FROM OPERATING ACTIVITIES:		
Receipts from contract holders	\$ 7,190	\$ 8,280
Interest received	111,135	122,643
Interest payments	(103,043)	(112,187)
Payments to suppliers and employees	(20,340)	(23,787)
Other payments	(19,218)	(5,065)
Net cash used in operating activities	<u>(24,276)</u>	<u>(10,116)</u>
CASH FLOWS FROM NONCAPITAL FINANCING ACTIVITIES:		
Proceeds from sales of bonds	-	191,200
Maturities of bonds payable	(97,015)	(75,195)
Early redemption of bonds payable	(87,955)	(72,605)
Increase to deferred finance costs	-	(2,145)
Net decrease (increase) in due from Veterans Debenture Revenue Fund	<u>43</u>	<u>(20)</u>
Net cash (used in) provided by noncapital financing activities	<u>(184,927)</u>	<u>41,235</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net increase in receivables under contracts of purchase	(34,401)	(142,306)
Decrease in guaranteed investment contracts	(4,121)	4,180
Purchase of land, improvements, and equipment	<u>-</u>	<u>(32)</u>
Net cash used in investing activities	<u>(38,522)</u>	<u>(138,158)</u>
DECREASE IN CASH AND CASH EQUIVALENTS	(247,725)	(107,039)
CASH AND CASH EQUIVALENTS:		
Beginning of year	<u>533,866</u>	<u>640,905</u>
End of year	<u><u>\$ 286,141</u></u>	<u><u>\$ 533,866</u></u>
RECONCILIATION OF (DEFICIENCY) EXCESS OF REVENUES (UNDER) OVER EXPENSES TO NET CASH USED IN OPERATING ACTIVITIES:		
Deficiency of revenues under expenses	\$ (22,256)	\$ (3,783)
Adjustments to reconcile to net cash used in operating activities:		
Bond amortization	2,390	1,119
Change in allowance for uncollectible contracts	11,293	(2,115)
Depreciation	38	546
Loss on sale of repossessed property	3,468	962
Effect of changes in assets and liabilities:		
Decrease in interest receivable — State of California's Surplus Money Investment Fund	3,145	2,624
(Increase) decrease in interest receivable — other investments	(6)	1
Increase in interest receivable — contracts of purchase	(1,845)	(1,024)
Increase in other real estate owned	(15,839)	(6,510)
Increase in other assets	(223)	(86)
(Decrease) increase in accrued interest and other liabilities	(1,517)	301
Decrease in due to other funds	(734)	(686)
Increase in other postretirement benefits	157	324
(Decrease) increase in fire and hazard insurance claims payable	(1,076)	331
Decrease in self-insured life and disability insurance loss reserve	<u>(1,271)</u>	<u>(2,120)</u>
NET CASH USED IN OPERATING ACTIVITIES	<u><u>\$ (24,276)</u></u>	<u><u>\$ (10,116)</u></u>

See notes to financial statements.

VETERANS FARM AND HOME BUILDING FUND OF 1943, DEPARTMENT OF VETERANS AFFAIRS, STATE OF CALIFORNIA

NOTES TO FINANCIAL STATEMENTS YEARS ENDED JUNE 30, 2009 AND 2008

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization and Description — The California Department of Veterans Affairs (the “Department”) is a separate legal entity and a cabinet-level agency of the State of California. A seven-member California Veterans Board (the “Board”) has policy oversight of the operations of the Department, all of whom are appointed by the Governor, subject to confirmation by the State Senate. The Veterans Farm and Home Building Fund of 1943 (the “Fund”) was established under the authority of the California Constitution to provide low-interest, long-term farm and home mortgage loan contracts to veterans living in California. The contract loan program has been continuous since 1922. Proceeds from the sale of general obligation bonds, periodically authorized by the vote of the people of California, and revenue bonds authorized by the legislature are used for contract loans to veterans. Expenses are primarily for debt service and administration of the program. The Fund is tax-exempt.

The financial statements represent only the activities of the Fund, and are not intended to present the financial position of the Department and the results of its operations and cash flows of its proprietary funds. The financial statements of the Fund are included in the financial statements of the state of California as the State represents the primary government and has ultimate oversight responsibility for the Fund.

Basis of Accounting — The Fund has been classified as a proprietary fund for accounting purposes. Revenues are recorded when earned and expenses are recognized as incurred.

Accounting and Reporting Standards — The Fund follows the Standards of Governmental Accounting and Financial Reporting, as promulgated by the *Governmental Accounting Standards Board* (GASB). The Fund has adopted the option under GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, which allows the Fund to apply all GASB pronouncements and only Financial Accounting Standards Board (FASB) pronouncements which date prior to November 30, 1989, unless those pronouncements conflict with or contradict GASB pronouncements; FASB Statements and Interpretations, Accounting Principles Board Opinions, and Accounting Research Bulletins of the committee on accounting procedures.

Use of Estimates in the Preparation of Financial Statements — The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents — The Fund considers all cash and highly liquid investments purchased with original maturities of three months or less to be cash equivalents. At June 30, 2009 and 2008, cash equivalents consisted of the State of California’s Surplus Money Investment Fund, carried at cost, which approximates fair value at June 30, 2009 and 2008.

Investments — The Department reports all investments at fair value except for certain nonparticipating fixed-interest investment contracts, which are valued at cost. The fair value of investments is based on published market prices and quotations from major investment brokers. Uncommitted bond proceeds for loans to veterans are reflected in the balance sheets within the investments balance.

Receivables Under Contracts of Purchase — Receivables under contracts of purchase consist of the remaining contract principal balance net of the allowance for uncollectible contracts.

Revenue Recognition — Interest is recognized as revenue when earned according to the terms of the loans. Interest accrual is only discontinued at the point of physical property repossession.

Allowance for Uncollectible Contracts — The allowance for uncollectible contracts is established through a provision charged to operations. The allowance is an amount that management believes will be adequate to absorb losses inherent in existing contracts and commitments to extend credit, based on evaluations of the collectability and prior loss experience of contracts and commitments to extend credit. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, specific problem contracts, commitments, and current and anticipated economic conditions that may affect the borrowers' ability to repay the obligation. The allowance for uncollectible contracts was \$13,927,000 and \$9,743,000 as of June 30, 2009 and 2008, respectively.

Contract Guarantees and Primary Mortgage Insurance — The Department collects a contract guarantee fee on all contracts with down payments less than 20% of purchase price. Such contracts are classified as high loan to value (HLTV) contracts. For eligible borrowers, the fee is used to purchase contract guarantees from the U.S. Department of Veterans Affairs (USDVA) or primary mortgage insurance (PMI). Prior to March 31, 2008, for certain HLTV contracts not eligible for USDVA guarantees, the Fund purchased PMI from Radian Guaranty Inc., formerly, the Commonwealth Mortgage Assurance Company. The PMI provides lifetime coverage on the HLTV contracts, not covered by USDVA guarantees, subject to an aggregate 2% deductible. The Department is responsible for any losses not covered by the USDVA guarantees or the PMI.

Other Real Estate Owned — Real estate acquired by the Fund by repossession is recorded at the lower of estimated fair value less estimated selling costs (fair value) or the carrying value of the related loan at the date of foreclosure. After repossession, the value of the underlying contract is written down to the estimated fair value of the real estate, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of any related income, are included in other expenses. Operating costs on foreclosed real estate are expensed as incurred. Costs incurred for physical improvements to foreclosed real estate are capitalized if the value is recoverable through future sale.

Fire and Hazard Insurance Plan — This insurance program is provided to eligible contract holders as part of the loan program. The difference between premiums charged to contract holders and claims and expenses incurred is included as a net amount in the statements of revenues, expenses, and changes in fund equity. Fire and hazard insurance claims payable include unpaid claims and incurred but not reported claims.

Self-Insured Life and Disability Insurance Plan — Beginning in 1984, the Department operated a self-funded protection plan whereby life and disability insurance was provided to eligible contract holders. This plan was terminated June 1, 1996. The life and disability benefits previously available to these members under the self-insured protection plan continue to be available to those contract holders who were receiving benefits at the time the plan was terminated. Loss reserves to satisfy these obligations of the protection plan, which include future disability and life benefits were derived from an

actuarial evaluation performed in 2006 that is updated internally on an annual basis. Significant actuarial assumptions and methodologies used to calculate the reserve are interest, mortality, disability, prepayment, and a long-term discount rate of 7%. Self-insured life and disability insurance loss reserve include unpaid claims, incurred but not reported claims and loss reserve.

Amortization of Bond Premiums, Discounts, and Issuance Costs — Premiums and discounts arising from the issuance of bonds and expenses incurred in connection with the issuance of bonds are capitalized and amortized using the monthly amortization method, which approximates the interest method.

Recently Adopted Accounting Standard — In fiscal year 2007-2008, the Fund adopted a new statement issued by the GASB. GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions*. As stated in GASB Statement No. 45, this statement establishes standards for the measurement, recognition, and display of other postemployment benefits (OPEB) costs and related liabilities (assets), note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. OPEB includes postemployment healthcare, as well as other forms of postemployment benefits (e.g., life insurance) when provided separately from a pension plan. GASB Statement No. 45 improves the relevance and the usefulness of financial reporting by: (i) recognizing the cost of benefits in periods when the related services are received by the employer; (ii) providing information about the actuarial accrued liabilities for promised benefits associated with past services and whether and to what extent those benefits have been funded; (iii) providing information useful in assessing potential demands on the employer's future cash flows.

The financial reporting impact resulting from the implementation of GASB Statement No. 45 for fiscal year 2008 was the recognition of an additional expense and liability of \$324,000 in the Fund's financial statements for fiscal year 2007-2008 (see Note 10).

New Accounting Standard — GASB issued a statement for future reporting periods. In June 2008, the GASB issued Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*, effective for the period beginning after June 15, 2009, with earlier application encouraged. GASB Statement No. 53 addresses the recognition, measurement, and disclosure of information regarding derivative instruments. The Fund does not expect the adoption of this statement to have a material impact on its financial statements as the Fund currently does not hold any derivative instruments.

2. CASH, CASH EQUIVALENTS, AND INVESTMENTS

Cash in State Treasury — Cash in the State Treasury represents amounts held in the Fund's general operating accounts with the State Treasury. These monies are pooled with the monies of other state agencies and invested by the State Treasurer's office. These assets are not individually identifiable. At June 30, 2009 and 2008, the carrying amount of the Fund's deposits in State Treasury was \$19,590,000 and \$15,178,000, respectively.

State of California's Surplus Money Investment Fund (SMIF) — Cash in the SMIF represents the value of the deposits in the State Treasurer's pooled investment program, which is equal to the dollars deposited in the program. The fair value of the position in the program may be greater or less than the value of the deposits, with the difference representing the unrealized gain or loss. As of June 30, 2009 and 2008, this difference was immaterial to the valuation of the program. The pool is run with "dollar-in, dollar-out" participation. There are no share-value adjustments to reflect changes in fair value. For a complete description of the risks related to this program refer to the State of California Comprehensive Annual Financial Report (CAFR) that includes information about the State's pooled investment program. At June 30, 2009 and 2008, the carrying amount of the Fund's deposits in SMIF was \$266,551,000 and \$518,688,000, respectively.

Investments — Investment of bond funds is restricted by applicable California law and the various bond resolutions associated with each issuance, generally, to certain types of investments. These investments include direct obligations of the U.S. government and its agencies and investment agreements with financial institutions or insurance companies rated within the top two ratings of a nationally recognized rating service. The investments with the insurance administrator, held as a deposit in accordance with a master agreement for the remaining active life and disability insurance program for disabled contract holders, is authorized by California law. The Department monitors the creditworthiness of all companies that hold investments of the Fund.

The Fund's investment in nonparticipating fixed-interest contracts, carried at cost, were \$29,776,000 and \$25,842,000 as of June 30, 2009 and 2008, respectively. The interest rates on investment agreements are fixed and range from 5.30% to 6.46%. The investment agreements expire from 2010 to 2032.

Investment Risk Factors — Many factors can affect the value of investments. Some, such as credit risk, custodial credit risk, concentration of credit risk, and interest rate risk, may affect both equity and fixed-income securities. Equity and debt securities respond to such factors as economic conditions, individual company earnings performance, and market liquidity, while fixed-income securities are particularly sensitive to credit risks and changes in interest rates. It is the investment policy of the Fund to invest substantially all of its funds within SMIF and the remainder in investment contracts or with insurance administrators to limit the Fund's exposure to most types of investment risk.

Credit Risk — Fixed-income securities are subject to credit risk, which is the chance that a issuer will fail to pay interest or principal in a timely manner or that negative perceptions of the issuer's ability to make these payments will cause security prices to decline. Certain fixed-income securities, including obligations of the U.S. government or those explicitly guaranteed by the U.S. government, are not considered to have credit risk. At June 30, 2009 and 2008, the Fund does not have significant investments exposed to credit risk.

Custodial Credit Risk — Custodial credit risk is the risk that in the event of the failure of the custodian, the investments may not be returned. At June 30, 2009 and 2008, the Fund did not have any investments exposed to custodial credit. All investments are held by the State of California.

Concentration of Credit Risk — Concentration of credit risk is the risk associated with a lack of diversification, such as having substantial investments in a few individual issuers, thereby exposing the Fund to greater risks resulting from adverse economic, political, regulatory, geographic, or credit developments. At June 30, 2009 and 2008, the Fund does not have a significant concentration of credit risk.

Interest Rate Risk — Interest rate risk is the risk that the value of fixed-income securities will decline due to decreasing interest rates. The terms of a debt investment may cause its fair value to be highly sensitive to interest rate changes. At June 30, 2009 and 2008, the Fund does not have any significant debt investments that are highly sensitive to changes in interest rates.

The Fund's investments include amounts held in trust fund with insurance administrators and various guaranteed investment contracts (GICs) with insurance companies. The GICs are collateralized by investments held by the State of California on behalf of the Fund. Additionally, the Fund only invests in investment agreements issued by highly rated insurance companies and management regularly monitors the credit rating of the insurance companies issuing such investment agreements as part of monitoring the Fund's exposure to credit risk.

The Fund's investments as of June 30, 2009 and 2008, are as follows (in thousands):

	2009	2008
Amounts held in trust fund with insurance administrators	\$ 6,590	\$ 6,403
Investment agreements (at cost)	<u>29,776</u>	<u>25,842</u>
Total investment	<u>\$ 36,366</u>	<u>\$ 32,245</u>

3. RECEIVABLES UNDER CONTRACTS OF PURCHASE

The Fund retains title to all real property subject to contracts of purchase until the contract is satisfied. The veterans' contracts have original terms of 25–30 years and bear interest at rates of 4.25%–9.75%, depending on the age and type of contract and the classification of the contract holder. Receivables under contracts of purchase, net of allowance for uncollectible contracts as of June 30, 2009 and 2008, were as follows (in thousands):

	2009	2008
Receivables under contracts of purchase	\$ 1,701,943	\$ 1,674,651
Less allowance for uncollectible contracts of purchase	<u>(13,927)</u>	<u>(9,743)</u>
	1,688,016	1,664,908
Less current portion	<u>(46,923)</u>	<u>(49,133)</u>
Receivables under contracts of purchase — net	<u>\$ 1,641,093</u>	<u>\$ 1,615,775</u>

4. LAND, IMPROVEMENTS, AND EQUIPMENT

Land, improvements, and equipment as of June 30, 2009 and 2008, consisted of the following (in thousands):

	2009	2008
Land	\$ 443	\$ 443
Buildings	12,410	12,410
Equipment	<u>3,440</u>	<u>3,440</u>
	16,293	16,293
Less accumulated depreciation	<u>(15,761)</u>	<u>(15,723)</u>
Land, improvements, and equipment — net	<u>\$ 532</u>	<u>\$ 570</u>

5. BONDS PAYABLE

Bonds payable as of June 30, 2009 and 2008, included the following (in thousands):

	2009	2008
General obligation bonds of the State of California, fixed annual interest rates from 4.6% to 9.8% due in varying annual installments through 2042 (subject to varying redemption provisions)	\$ 1,172,330	\$ 1,324,595
Home purchase revenue bonds, fixed annual interest rates from 4.6% to 5.5%, due in varying annual installments through 2042 (subject to varying redemption provisions)	694,805	717,010
Commercial paper, due to the State of California, due in full December 2008	-	10,500
Total	1,867,135	2,052,105
Less:		
Discounts	(1,913)	(2,025)
Premium	257	268
Unamortized bond origination costs	(12,029)	(14,064)
Unamortized bond redemption premiums	(938)	(1,192)
Total	1,852,512	2,035,092
Less — current portion	67,025	97,015
Noncurrent portion	<u>\$ 1,785,487</u>	<u>\$ 1,938,077</u>

In the subsequent fiscal year, on July 1, 2009, the Department issued a bond call and paid \$55,970,000 in principal and \$251,865 in interest for a total of \$56,221,865 in debt service.

A summary of debt service requirements for the next five years and to maturity is as follows (in thousands):

Fiscal Years Ending June 30	Principal	Interest
2010	\$ 122,995	\$ 89,929
2011	34,400	84,570
2012	47,510	82,227
2013	25,335	80,535
2014	47,790	78,811
2015–2019	294,595	351,852
2020–2024	369,295	271,483
2025–2029	442,950	167,988
2030–2034	276,560	80,442
2035–2039	146,455	30,242
2040–2044	59,250	4,388
Total	<u>\$ 1,867,135</u>	<u>\$ 1,322,467</u>

General obligation bonds of the State of California are payable in accordance with the various veterans bond acts by the State General Fund. The full faith and credit of the State of California is pledged for the

payment of both principal and interest. All general obligation bonds have an equal claim against the General Fund of the State of California. These bonds are included as obligations of the Fund when the proceeds from bond sales are received. The repayment for the bonds is the responsibility of the Fund. The authorized and unissued bonds under the Veterans Bond Act of 2000 were \$263,610,000 at June 30, 2009 and \$263,610,000 at June 30, 2008. In November 2008, California voters approved the Veterans Bond Act of 2008 (2008 Bond Act) totaling \$900,000,000. As of June 30, 2009, no bonds have been issued under the 2008 Bond Act.

Home purchase revenue bonds are special obligations of the Department payable solely from, and by a pledge of, an undivided interest in the assets of the Fund and the Veterans Debenture Revenue Fund, a separate fund of the Department. The undivided interest in the net revenues of the Fund is secondary and subordinate to any interest or right in the 1943 Fund of the people of the State of California and of the holders of general obligation veterans bonds. At any point in time, authorized and unissued revenue bonds equal the \$1.5 billion ceiling authorized in 1987 less revenue bonds outstanding at that time. At June 30, 2009 and 2008, authorized and unissued revenue bonds were \$805,195,000 and \$782,990,000, respectively.

During fiscal year 1998, the Department amended the revenue bond resolution provisions regarding the bond reserve account in the Veterans Debenture Revenue Fund (a separate entity). The revenue bond resolution requires the establishment and maintenance of a bond reserve account in an amount equal to at least 3% of the aggregate outstanding principal amount of all revenue bonds with interest rates fixed to maturity. To calculate the reserve requirement, the Ninth Supplemental Resolution established, with respect to the revenue bonds with interest rates fixed to maturity issued pursuant to such resolution (1997 Series A, B, and C Bonds, 1998 Series A Bonds, 1999 Series A and B Bonds, 2000 Series A, B, and C Bonds, and 2001 Series A Bonds), a requirement equal to at least 7% of the outstanding principal amount of such revenue bonds, and for series 2002 an amount equal to 5% of the outstanding principal amount. Amounts in the bond reserve account shall be used solely for the purposes of paying the principal of and the interest on the revenue bonds and for making mandatory sinking fund account payments on revenue bonds. Amounts on deposit in the bond reserve account as of any date, in excess of the bond reserve requirement, may be transferred out of the Veterans Debenture Revenue Fund to the Fund, at the request of the Department. Investment earnings of the Veterans Debenture Revenue Fund are transferred to the Fund. At June 30, 2009 and 2008, the total assets of the Veterans Debenture Revenue Fund are shown as a receivable of the Fund. Complete financial statements of the Veterans Debenture Revenue Fund, Department of Veterans Affairs, State of California can be obtained by contacting the Department.

6. BOND REDEMPTION AND REFUNDING

For the year ended June 30, 2008, the Department issued general obligation bonds and home purchase revenue bonds totaling \$91,200,000 and \$100,000,000, respectively. The Department did not issue either general obligation bonds or home purchase revenue bonds for the year ended June 30, 2009.

The Department redeemed \$18,355,000 for home purchase revenue bonds and \$69,620,000 for general obligation bonds, to pay off high coupon debt prior to maturity. The Department also paid off \$81,175,000 of high coupon non-callable debt, and \$5,340,000 of callable debt, due to maturity. Currently, the Department has no outstanding commercial paper.

The remaining non-callable bond debt balance is \$79,855,000 as of June 30, 2009, and is scheduled to be paid in full October 2010.

7. FIRE AND HAZARD INSURANCE

Fire and hazard insurance coverage is provided on behalf of contract holders for all of the single-family detached homes subject to the CalVet contracts of sale. The program is funded by amounts charged to contract holders, which are considered appropriate to cover losses incurred, the premiums paid for excess insurance coverage, claims adjusting costs, and administration fees. From the amounts charged to the contract holders, the Department pays losses up to a \$2,500,000 deductible, with an annual aggregate deductible of \$10,000,000. Several insurance carriers supply an additional \$50,000,000 of coverage in excess of these deductibles. The claims loss expense is based on our third-party administrator's estimate of incurred but not reported claims, which is based on the historical trends and loss experience within the portfolio.

The excess of premiums charged to contract holders over claims, expenses, and change in loss reserves for the years ended June 30, 2009 and 2008, was as follows (in thousands):

	2009	2008
Amounts charged to contract holders	\$ 4,929	\$ 5,271
Less:		
Claims loss expense	(2,350)	(5,379)
Master policy premium	(722)	(782)
Administrative fees	(209)	(310)
Third-party contract — replacement value project		
	<u>\$ 1,648</u>	<u>\$ (1,200)</u>

8. SELF-INSURED LIFE AND DISABILITY PROTECTION PLAN

The Department was responsible for a self-insured life and disability protection plan for all contract holders until June 1, 1996. Except for existing contract holders receiving benefits at that date, the self-insured life and disability protection plan were replaced by existing life and disability insurance plans provided by commercial insurers.

As of June 30, 2009, the Department remains self-insured for approximately 170 remaining contract holders. Under the provisions of the self-insured plan benefits continue until the beneficiary returns to active employment, dies or their contract is paid off. Loss reserves for these obligations have been actuarially determined.

The excess of claims expenses, changes in loss reserves, and administrative expenses over plan revenues whose coverage continues as obligations of the self-funded life and disability protection plan for the years ended June 30, 2009 and 2008, was as follows (in thousands):

	2009	2008
Claims expenses:		
Life insurance program	\$ (166)	\$ (162)
Disability insurance program	<u>(1,609)</u>	<u>(1,954)</u>
Total claims expenses	(1,775)	(2,116)
Decrease in estimated loss reserves	<u>1,271</u>	<u>2,120</u>
Net claims revenue and change in loss reserves	<u>(504)</u>	<u>4</u>
Plan revenues:		
Life insurance program	14	19
Disability insurance program	<u>48</u>	<u>58</u>
Total	62	77
Administrative fees	<u>(19)</u>	<u>(24)</u>
Net (expense) revenue — self-insured life and disability insurance program	<u>\$ (461)</u>	<u>\$ 57</u>

The change in the self-insured life and disability insurance loss reserve for the years ended June 30, 2009 and 2008, was as follows (in thousands):

	2009	2008
Self-insured life and disability insurance loss reserve — beginning of year balance	\$ 6,761	\$ 8,881
Insurance claims payable	-	-
Change in estimated loss reserve	<u>(1,271)</u>	<u>(2,120)</u>
Self-insured life and disability insurance loss reserve — end of year balance	<u>\$ 5,490</u>	<u>\$ 6,761</u>

9. COMMITMENTS AND CONTINGENCIES

Commitments — As of June 30, 2009, the Fund had loan commitments to veterans for the purchase of properties under contracts of sale of approximately \$13,477,167.

The Fund leases several buildings used as district offices. Rent expense for the years ended June 30, 2009 and 2008, was \$237,180 and \$239,713, respectively. Minimum annual rentals under operating leases as of June 30, 2009, are as follows (in thousands):

2010	\$ 102
2011	48
2012	<u>24</u>
Total	<u>\$ 174</u>

Contingencies — The Fund is subject to a variety of legal actions arising out of the normal course of business. Based upon information available to the Fund, its review of such lawsuits and consultation with legal counsel, the Fund believes the liability relating to these actions, if any, would not have a material adverse effect on the Fund’s financial statements.

10. EMPLOYEE BENEFIT PLANS

Public Employees’ Retirement Fund:

Plan Description — The Fund contributes to the Public Employees’ Retirement Fund (PERF) as part of the State of California, the primary government. The PERF is a cost-sharing multiple-employer defined benefit pension plan administered by the California Public Employment Retirement System (“CalPERS”). CalPERS provides retirement, death, disability, and postretirement health care benefits to members as established by state statute. CalPERS issues a publicly available CAFR that includes financial statements and required supplementary information for the Public Employees’ Retirement Fund. A copy of that report may be obtained from CalPERS, Central Supply, P.O. Box 942715, Sacramento, CA 95229-2715 or via the Internet at www.calpers.ca.gov.

Funding Policy — Contributions to the Plan are funded by both the Department and the employee, and are actuarially determined by CalPERS based on covered compensation. State employees, with the exception of employees in the second-tier plan, are required to contribute to the fund. The contribution rates of active plan members are based on 5% of compensation in excess of \$513 each month.

Contributions by the Department to the Plan for the years ended June 30, 2009 and 2008, were approximately \$963,000 and \$1,023,000, or approximately 14.3% and 15.5% of participants’ salaries, respectively.

Annual Pension Cost — For fiscal years June 30, 2009 and 2008, the Department’s annual pension cost was equal to the Department’s required and actual contributions. The required contribution is determined by actuarial valuation using the entry age normal actuarial cost method. The most recent actuarial valuation available is as of June 30, 2007, which actuarial assumptions included (a) 7.75% investment rate of return compounded annually, (b) projected salary increases that vary based on duration of service, and (c) overall payroll growth factor of 3.25% annually. Both (a) and (b) included an inflation component of 3.0% and a 0.25% per annum productivity increase assumption. The actuarial value of CalPERS assets attributable to the Department was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a two- to five-year period.

The most recent actuarial valuation of the PERF indicated that there was an unfunded actuarial accrued liability. The amount of the underfunded liability applicable to each agency or department cannot be determined. Trend information, which presents CalPERS progress in accumulating sufficient assets to pay benefits when due, is presented in the June 30, 2008, CalPERS CAFR.

State of California Other Postemployment Benefit Plans:

Plan Description — The Fund contributes to the State of California Other Postemployment Benefit Plans (“SCOPEB”) as part of the State of California, the primary government. The SCOPEB is a cost-sharing multiple-employer defined benefit postemployment healthcare plan administered by the State of California and CalPERS. CalPERS provides retirement, death, disability, and postretirement health care benefits to members as established by state statute. CalPERS issues a publicly available CAFR that includes financial statements and required supplementary information for the SCOPEB. A copy of that report may be obtained from CalPERS, Central Supply, P.O. Box 942715, Sacramento, CA 95229-2715 or via the Internet at www.calpers.ca.gov.

Funding Policy — The State Controller’s Office sets the employer contribution rate based on the annual required contribution of the employers (ARC), an amount actuarially determined in accordance with the parameters of GASB Statement No. 45. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost each year and amortize any unfunded actuarial liabilities (or funding excess) of the plan over a period not to exceed 30 years. The Fund’s estimated unfunded other postemployment benefit cost was \$481,000 and \$324,000 for the years ended June 30, 2009 and 2008, respectively. The Fund recognized \$157,000 and \$324,000 in expense for the years ended June 30, 2009 and 2008, respectively.

The Department has expensed the above amounts in the appropriate fiscal years and a reserve has been established to transfer to the State’s trust account once the account is established. The Department has fully funded their OPEB costs by setting aside 100% of the established amounts to fund this expense.

* * * * *

EXHIBIT 2
CERTAIN DEPARTMENT FINANCIAL INFORMATION
AND OPERATING DATA

Contracts of Purchase

Set forth below is certain financial information regarding Contracts of Purchase.

Existing Contracts of Purchase

The following charts describe the current loan-to-value ratio of Contract of Purchase, geographic distribution, high LTV distribution, and portfolio age data of Contracts of Purchase financed under the Program as of March 31, 2010 using proceeds of Veterans G.O. Bonds, Revenue Bonds and other amounts under the 1943 Fund.

Current Loan-to-Value Ratio of Contracts of Purchase⁽¹⁾⁽²⁾

	<u>Uninsured</u>	<u>Original Radian Insured⁽⁵⁾</u>	<u>Additional Radian Insured⁽⁵⁾</u>	<u>VA Guaranteed</u>	<u>Total</u>
Single Family Homes					
Less than 30% LTV	\$ 60,870	\$ 1,091	\$ 173	\$ 206	\$ 62,339
30-49% LTV	97,282	4,901	900	1,093	104,174
50-59% LTV	94,863	10,892	1,510	1,265	108,529
60-69% LTV	139,413	33,982	6,313	3,363	183,070
70-79% LTV	127,576	29,434	57,670	20,818	235,497
Sub-total	\$ 520,002	\$ 80,299	\$ 66,564	\$ 26,744	\$ 693,607
80-84% LTV	\$ 12,976	\$ 11,972	\$ 113,632	\$ 27,956	\$ 166,534
85-89% LTV	16,938	1,269	133,117	39,421	190,743
90-94% LTV	38,185	-	66,403	83,096	187,683
95-97% LTV	21,942	-	1,147	117,785	140,872
Sub-total	\$ 90,039	\$ 13,241	\$ 314,296	\$ 268,256	\$ 685,831
Greater than 97% LTV	\$ 4,595	\$ 785	\$ 149	\$ 120,791	\$ 126,318
Other Property Types					
Farms.....	\$ 2,476	\$ 160	\$ 1,128	\$ -	\$ 3,762
Mobile Homes in Parks	23,019	241	25,519	-	48,778
Homes under Construction	1,712	-	-	-	1,712
Sub-total	\$ 27,206	\$ 400	\$ 26,646	\$ -	\$ 54,251
Special Status Contracts of Purchase					
Real Estate Owned ⁽³⁾	\$ 13,264	\$ -	\$ -	\$ 1,021	\$ 14,284
Cancelled.....	\$ 5,289	\$ 317	\$ 8,363	\$ 14,294	\$ 28,261
Disability Program ⁽⁴⁾	\$ 1,539	\$ 619	\$ -	\$ -	\$ 2,157
Sub-total	\$ 20,091	\$ 935	\$ 8,363	\$ 15,314	\$ 44,702
Total Portfolio	\$ 661,931	\$ 95,658	\$ 416,017	\$ 431,104	\$ 1,604,708

⁽¹⁾ Amounts in thousands.

⁽²⁾ LTV based on current Contracts of Purchase balance divided by original appraised value of the property, except when the Department updates the appraised value of the home when the veteran applies for a home improvement loan. In such cases, the LTV is calculated with the new appraised value.

⁽³⁾ Repossessed properties and delinquent Contracts of Purchase carried as REO on financial statements.

⁽⁴⁾ Contracts of Purchase where payments are made on behalf of veterans by the Department's life and disability coverage plan.

⁽⁵⁾ The Radian Policies provides coverage for aggregate losses incurred on covered Contracts of Purchase following property disposition, above an aggregate 2% deductible based upon a percentage of the originally insured balances of the applicable Contracts of Purchase. As of December 31, 2009 the aggregate 2% deductible was \$41,672,000 with accumulated total claims to date of \$9,768,000 leaving a difference of \$31,904,000 outstanding. As many of the Contracts of Purchase insured under the Original Radian Policy have high originally insured balances but have been paid down significantly over the life of such Contract of Purchases, the Department does not anticipate that it will incur losses on Contracts of Purchase in excess of the 2% deductible. As such, the Department does not expect to collect any amounts under the Radian Policies. For more information see APPENDIX B – "THE PROGRAM – USDVA Guaranty Program; Loan Insurance."

Geographic Distribution of Contracts of Purchase
Approximate Current Contract Balance
as of March 31, 2010

County	
San Diego	\$ 180,835
Riverside	169,937
Sacramento	119,658
Los Angeles	108,838
San Bernardino	101,276
Fresno	97,138
Kern	87,416
Shasta	52,469
Solano	50,240
Orange	43,035
Placer	39,236
Kings	38,457
San Joaquin	35,168
Butte	33,383
Tulare	32,808
Other Northern California Counties.....	258,215
Other Central California Counties	119,469
Other Southern California Counties.....	37,130
Statewide—California	<u>\$ 1,604,708</u>

Portfolio Age Data⁽¹⁾

Origination Date	Number of Contracts	% of Contracts in Portfolio	Current Principal Balance⁽²⁾	Principal Balance as a Percent of Total Portfolio
1998 and Prior	3,595	31.4%	\$ 146	9.1%
1999	432	3.8%	46	2.9%
2000	624	5.4%	70	4.4%
2001	206	1.8%	21	1.3%
2002	387	3.4%	49	3.0%
2003	905	7.9%	162	10.1%
2004	1,153	10.1%	219	13.6%
2005	791	6.9%	142	8.9%
2006	1,000	8.7%	219	13.6%
2007	969	8.5%	224	14.0%
2008	1,000	8.7%	244	15.2%
2009	354	3.1%	58	3.6%
2010	41	0.4%	4	0.2%
Total	11,457	100.0%	\$ 1,604	100.0%

⁽¹⁾ As of March 31, 2010.

⁽²⁾ Amounts in millions.

Contracts with 97% LTV ⁽¹⁾ or Higher as of March 31, 2010

County	USDVA Insured⁽²⁾	Un- Insured	Total Contracts with 97% + LTV	Outstanding Balance of 97%+ LTV Contracts⁽⁴⁾
San Diego	95	0	95	\$ 34,905
Riverside	73	1	74	24,624
Kern	51	0	51	11,731
Los Angeles	50	1	51	18,798
Sacramento	48	1	49	14,489
Fresno	43	0	43	11,076
Solano	29	1	30	11,966
San Bernardino	28	0	28	7,241
Shasta	24	2	26	4,945
Placer	23	0	23	8,007
Orange	21	1	22	8,682
Butte	20	1	21	4,228
Kings	19	0	19	4,661
Contra Costa	18	0	18	6,787
San Joaquin	14	0	14	3,437
Yuba	14	0	14	3,643
Alameda	13	0	13	5,128
Humboldt	11	0	11	3,214
Lake	10	0	10	2,154
Santa Barbara	10	0	10	4,147
All Other Counties ⁽³⁾	120	4	124	34,957
Total	734	12	746	\$ 228,811

⁽¹⁾ LTV based on current Contracts of Purchase balance divided by original appraised value of the property, except when the Department updates the appraised value of the home when the veteran applies for a home improvement loan. In such cases, the LTV is calculated with the new appraised value. Includes "Single Family Homes," "Other Property Types" and "Special Status Contracts of Purchase" as defined above in the "Current Loan-to-Value Ratio of Contracts of Purchase" table.

⁽²⁾ See "—THE PROGRAM – USDVA Guaranty Program; Loan Insurance– USDVA Guaranty Program."

⁽³⁾ All counties not listed individually had less than 10 total contracts with a LTV of 97% or higher as defined above.

⁽⁴⁾ Amounts in thousands.

Contracts of Purchase Origination and Principal Repayment Experience

The following tables represent, respectively, a historical picture of Contract of Purchase originations since the 1990 fiscal year and selected principal repayments with respect to Contracts of Purchase since the 1990 fiscal year.

New Contracts of Purchase During the Fiscal Year

Fiscal Year Ending June 30	<u>Veterans G.O. Bonds</u>		<u>Pre-Ullman Moneys</u>		<u>Revenue Bonds</u>		<u>Total</u>	
	<u>Number⁽¹⁾</u>	<u>Amount</u>	<u>Number⁽¹⁾</u>	<u>Amount</u>	<u>Number⁽¹⁾</u>	<u>Amount</u>	<u>Number⁽¹⁾</u>	<u>Amount</u>
1990	2,097	\$187,445,600	--	--	522	\$38,150,800	2,619	\$225,596,400
1991	1,927	200,393,500	--	--	359	29,189,600	2,286	229,583,100
1992	1,086	111,600,500	--	--	388	34,671,600	1,474	146,272,100
1993	740	94,417,100	--	--	286	27,443,800	1,026	121,860,900
1994	843	117,213,779	--	--	337	34,740,536	1,180	151,954,315
1995	2,109	286,178,376	--	--	822	84,860,894	2,931	371,039,270
1996	762	107,751,444	--	--	222	22,723,617	984	130,475,061
1997	766	118,344,636	--	--	201	21,853,933	967	140,198,569
1998	615	99,224,002	188	\$17,716,376	164	18,871,066	967	135,811,444
1999	758	129,521,359	575	92,728,280	274	33,284,343	1,607	255,533,982
2000	1,045	185,180,534	1,725	333,328,690	708	92,214,409	3,478	610,723,633
2001	844	135,498,480	1,211	232,445,146	697	101,175,512	2,752	469,119,138
2002	334	56,887,867	416	74,915,487	204	27,178,525	954	158,981,879
2003	357	68,105,508	508	99,105,265	123	16,285,625	988	183,496,398
2004	444	97,223,818	1,173	274,187,085	165	26,109,792	1,782	397,520,696
2005	285	72,958,181	702	181,075,275	178	37,152,048	1,165	291,185,504
2006	198	48,999,641	898	230,993,270	5	831,638	1,101	280,824,549
2007	74	19,751,777	764	173,744,639	68	11,349,372	906	204,845,788
2008	214	38,721,589	428	139,470,089	417	111,589,399	1,059	289,781,076
2009	255	83,697,271	161	42,079,390	263	66,032,084	679	191,808,746
2010 ⁽²⁾	25	8,118,333	23	5,688,660	59	9,970,629	107	23,777,622

(1) Number of new Contracts of Purchase does not include home improvement loans.

(2) As of March 31, 2010.

Selected Principal Flows with respect to Contracts of Purchase Funded by both Veterans G.O. Bonds and Revenue Bonds (Dollar Amounts in Thousands)

Fiscal Year Ending June 30	Contracts Funded During Year	Contract Prepayments During Year	Other Principal Receipts-Losses During Year	Contract Balance at End of Year	Average Rate on all Outstanding Contracts	Average of Monthly FHLMC 30-year Conventional Loan Rate	Annual Average Prepayment Rate	Annual Average Origination Rate
Principal Flows					Rates			
1992	\$146,272	\$246,150	\$ 92,975	\$2,789,879	8.0%	9.0%	8.5%	5.1%
1993	121,861	273,817	105,629	2,532,294	8.0	8.0	10.3	4.6
1994	151,954	359,749	98,773	2,225,726	8.0	7.3	15.1	6.4
1995	371,039	111,984	74,706	2,410,075	7.8	8.7	4.8	16.0
1996	130,475	141,767	92,521	2,306,262	8.0	7.5	6.0	5.5
1997	140,199	111,254	106,027	2,229,180	8.0	8.0	4.9	6.2
1998	135,812	172,134	94,106	2,098,752	7.7	7.2	8.0	6.3
1999	255,534	183,776	101,254	2,069,256	6.9	6.9	8.8	12.3
2000	610,724	138,401	106,522	2,435,056	6.8	8.1	6.1	27.1
2001	469,119	189,902	91,033	2,623,241	6.8	7.5	7.5	18.5
2002	158,982	330,068	86,556	2,365,599	6.8	6.9	13.2	6.4
2003	183,496	701,785	74,643	1,772,667	6.7	5.9	33.9	8.9
2004	397,521	576,907	53,833	1,539,448	6.3	5.9	34.8	24.0
2005	291,186	272,044	70,564	1,488,026	5.9	5.8	18.0	19.2
2006	280,825	204,037	51,481	1,513,333	5.8	6.2	13.6	18.7
2007	204,846	132,207	50,403	1,535,569	5.8	6.4	8.7	13.4
2008	289,781	82,575	53,915	1,688,860	5.8	6.2	5.1	18.0
2009	191,809	84,010	56,756	1,739,903	5.9	5.6	4.9	11.2
2010 ⁽²⁾	23,777	102,777	56,444	1,604,459	5.7	5.0	8.2	1.9
	\$ 4,555,212	\$ 4,415,344	\$ 1,518,141					

Reservation rates on new Contracts of Purchase for period:

<u>Period</u>	<u>Veterans G.O. Bonds⁽¹⁾</u>	<u>Pre-Ullman Moneys</u>	<u>Revenue Bonds</u>
Prior to January 1, 1999, substantially all newly originated Contracts have the same rate as the then outstanding Contracts.			
January 1, 1999 thru June 30, 2000	6.65%	6.65%	5.95%
July 1, 2000 thru February 28, 2001	7.50%	7.95%	6.95%
March 1, 2001 thru May 31, 2001	6.50%	7.95%	6.40%
June 1, 2001 thru August 31, 2001	6.50%	7.10%	6.40%
September 1, 2001 thru April 1, 2002	6.25%	6.50%	6.00%
April 2, 2002 thru July 31, 2002	5.90%	6.50%	5.80%
August 1, 2002 thru December 1, 2002	5.50%	6.00%	5.80%
December 2, 2002 thru June 15, 2003	4.99%	5.40%	5.25%
June 16, 2003 thru September 1, 2003	4.25%	4.50%	4.50%
September 1, 2003 thru September 15, 2003	4.25%	4.99%	4.50%
September 16, 2003 thru May 5, 2004	4.50%	4.99%	4.50%
May 6, 2004 thru June 1, 2004	4.75%	5.25%	4.75%
June 2, 2004 thru December 13, 2004	4.95%	5.50%	5.10%
December 14, 2004 thru April 3, 2005	4.95%	5.50%	5.50%
April 4, 2005 through December 9, 2005	5.15%	5.50%	5.50%
December 10, 2005 through February 5, 2006	5.50%	5.50%	5.50%
February 6, 2006 through March 14, 2006	5.70%	5.70%	5.70%
March 15, 2006 through April 25, 2006	6.00%	6.00%	6.00%
April 26, 2006 through July 5, 2006	6.25%	6.25%	6.25%
July 6, 2006 through December 19, 2006 ⁽¹⁾	6.50%	6.50%	6.50%
December 20, 2006 through March 15, 2007	5.50%	6.10%	5.75%
March 16, 2007 through July 9, 2007	5.50%	6.10%	5.25%
July 10, 2007 through August 12, 2007	5.50%	6.45%	5.25%
August 13, 2007 through October 14, 2007	5.50%	6.55%	5.25%
October 15, 2007 through February 6, 2008	5.50%	6.55%	5.45%
February 7, 2008 thru June 25, 2008	5.50%	6.10%	5.45%
June 26, 2008 thru January 28, 2009	5.95%	6.20%	5.50%
January 29, 2009 thru June 30, 2009	5.95%	6.20%	5.75%

⁽¹⁾ Rates for contracts of purchase for mobile home in parks are 1% higher than the applicable established rates.

⁽²⁾ As of March 31, 2010.

Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments

The following table shows amounts expected to be available to fund Contracts of Purchase from Veterans G.O. Bonds and Revenue Bonds. Additional monies may become available to finance Contracts of Purchase through the future issuances of Veterans G.O. Bonds and Revenue Bonds. The Department has full discretion to use moneys available from prior, current or future bond issues in any order of priority it chooses. As of March 31, 2010, the Department had 64 pending applications for Contracts of Purchase in the aggregate amount of approximately \$6,615,235.

Amounts Expected to be Available to Fund Contracts of Purchase ⁽¹⁾

	Pre-Ullman Moneys			QVMB Proceeds			QMB Proceeds				
	Amount On Deposit on March 31, 2010	Amounts Expected to be Deposited or Applied to Contracts through August 1, 2010	Amount Expected to be Available on August 1, 2010	Amount On Deposit on March 31, 2010	Amounts Expected to be Deposited or Applied to Contracts through August 1, 2010	Amount Expected to be Available on August 1, 2010	Amount On Deposit on March 31, 2010	Amounts Expected to be Deposited or Applied to Contracts through August 1, 2010	Amount Expected to be Available on August 1, 2010	Current or expected Investment	Contracted Investment Rate (%)
Veterans G.O. Bond Proceeds and Recycling Subaccounts											
Pre-Ullman Moneys.....	\$ 19,307	\$ (5,000)	\$ 14,307	\$ 0	\$ 0	\$ 0				SMIF ⁽²⁾	Variable
QVMB Reimbursement.....	20,652	22,000	42,652	0	0	0				SMIF ⁽²⁾	Variable
Series CC/CD	0	0	0	185	(185)	0				SMIF ⁽²⁾	Variable
Series CE	0	0	0	185	(185)	0				SMIF ⁽²⁾	Variable
Series CG	0	0	0	0	0	0				SMIF ⁽²⁾	Variable
Other G.O. Bond Series.....	0	0	0	2,334	(2,000)	334				Various ⁽³⁾	Various
Total	\$ 39,959	\$ 17,000	\$ 56,959	2,704	(2,370)	334					
Revenue Bond Proceeds and Recycling Subaccounts											
2007 Series A.....							\$ 304	\$ (304)	\$ 0	SMIF ⁽²⁾	Variable
2007 Series B.....							113	(113)	0	SMIF ⁽²⁾	Variable
QMB Reimbursement.....	\$ 11,485	\$ (5,000)	\$ 6,485				0	0	0	SMIF ⁽²⁾	Variable
Other Revenue Bond Series	0	0	0				0	0	0	Various ⁽³⁾	Various
Total	\$ 11,485	\$ (5,000)	\$ 6,485				\$ 417	\$ (417)	\$ 0		
Grand Total	\$ 51,444	\$ 12,000	\$ 63,444	\$ 2,704	\$ (2,370)	\$ 334	\$ 417	\$ (417)	\$ 0		

⁽¹⁾ 000's omitted.

⁽²⁾ Surplus Money Investment Fund ("SMIF"). Amounts invested in SMIF may be withdrawn and reinvested at any time. See APPENDIX B – "THE 1943 Fund – Investments in the Surplus Money Investment Fund."

⁽³⁾ A portion of these funds are, or may be, placed in several investment agreements with different providers. See "– Additional Investments" below.

Cancellations and Delinquencies

Set forth in the tables below are (i) a comparative chart of delinquent, cancelled and repossessed Contracts of Purchase and certain comparative information regarding USDVA guaranteed loans during the same period, and a break down of delinquencies by county and origination date, (ii) distribution of delinquencies with respect to Contracts of Purchase by County and (iii) delinquencies with respect to Contracts of Purchase by origination date.

	<u>2000⁽¹⁾</u>	<u>2001⁽¹⁾</u>	<u>2002⁽¹⁾</u>	<u>2003⁽¹⁾</u>	<u>2004⁽¹⁾</u>	<u>2005⁽¹⁾</u>	<u>2006⁽¹⁾</u>	<u>2007⁽¹⁾</u>	<u>2008⁽¹⁾</u>	<u>2009⁽¹⁾</u>	<u>2010⁽²⁾</u>
Percentage of Number of Contracts of Purchase in the Department's Portfolio which are Delinquent											
30-60 days ⁽³⁾	3.91%	4.24%	3.52%	3.13%	2.97%	3.18%	2.93%	2.68%	2.75%	3.30%	3.69%
60+ days ⁽³⁾	2.88%	3.16%	2.43%	2.03%	1.43%	1.48%	0.85%	1.13%	1.64%	3.30%	4.11%
Cancelled Contracts and Real Estate in inventory ⁽³⁾⁽⁴⁾ ..	0.72%	0.69%	0.41%	0.32%	0.22%	0.12%	0.10%	0.21%	0.50%	1.13%	1.73%
Percentage of Number of USDVA Guaranteed Loans in the U.S. which are Delinquent⁽⁵⁾											
30-60 days	4.19%	4.71%	4.87%	4.83%	4.53%	4.49%	3.81%	3.66%	3.76%	3.76%	3.23%
60+ days	2.25%	2.65%	2.85%	3.15%	2.90%	3.10%	2.53%	2.44%	2.90%	4.01%	3.84%
Foreclosures in inventory	1.44%	1.20%	1.72%	1.49%	1.45%	1.50%	1.10%	1.02%	1.33%	2.07%	2.63%
Percentage of Number of USDVA Guaranteed Loans in California which are Delinquent⁽⁵⁾											
30-60 days	4.05%	4.57%	4.57%	4.67%	4.09%	3.52%	2.92%	2.56%	2.64%	2.57%	2.45%
60+ days	2.27%	2.49%	2.57%	2.79%	2.34%	2.11%	1.30%	1.33%	1.82%	2.78%	3.03%
Foreclosures in inventory	1.39%	0.93%	1.12%	0.93%	0.69%	0.60%	0.36%	0.44%	0.82%	1.50%	2.08%
Percentage of Number of Prime Loans in the U.S. which are Delinquent⁽⁵⁾											
30-60 days	1.78%	2.13%	2.17%	1.84%	1.69%	1.55%	1.54%	1.78%	2.08%	2.49%	2.23%
60+ days	0.55%	0.70%	0.83%	0.67%	0.63%	0.60%	0.70%	0.85%	1.65%	3.52%	4.67%
Foreclosures in inventory	0.57%	0.68%	0.87%	0.53%	0.49%	0.42%	0.41%	0.59%	1.42%	3.00%	3.41%
Percentage of Number of Prime Loans in California which are Delinquent⁽⁵⁾											
30-60 days	1.41%	1.63%	1.48%	1.25%	0.95%	0.82%	0.89%	1.28%	1.83%	2.34%	2.12%
60+ days	0.41%	0.47%	0.45%	0.39%	0.26%	0.20%	0.27%	0.62%	2.19%	5.39%	7.32%
Foreclosures in inventory	0.42%	0.36%	0.34%	0.18%	0.10%	0.07%	0.10%	0.41%	1.96%	4.25%	4.09%

	<u>2002⁽¹⁾</u>	<u>2003⁽¹⁾</u>	<u>2004⁽¹⁾</u>	<u>2005⁽¹⁾</u>	<u>2006⁽¹⁾</u>	<u>2007⁽¹⁾</u>	<u>2008⁽¹⁾</u>	<u>2009⁽¹⁾</u>	<u>2010⁽²⁾</u>
Percentage of Number of Contracts of Purchase in the Department's Portfolio which are Delinquent, Subject to Repayment/Forbearance Agreements or Cancelled Contracts and Real Estate in inventory									
30-60 days (Delinquent)	2.95%	2.77%	2.72%	2.96%	2.84%	2.56%	2.58%	2.86%	3.19%
30-60 days (Repayment/Forbearance Agreement)	0.57%	0.36%	0.25%	0.22%	0.09%	0.12%	0.17%	0.44%	0.50%
Total	3.52%	3.13%	2.97%	3.18%	2.93%	2.68%	2.75%	3.30%	3.69%
60+ days (Delinquent)	1.38%	1.32%	1.08%	1.17%	0.75%	1.03%	1.29%	2.25%	2.66%
60+ days (Repayment/Forbearance Agreement)	1.05%	0.71%	0.35%	0.31%	0.10%	0.10%	0.35%	1.05%	1.45%
Total	2.43%	2.03%	1.43%	1.48%	0.85%	1.13%	1.64%	3.30%	4.11%
Cancelled Contracts and Real Estate in inventory	0.39%	0.31%	0.19%	0.12%	0.10%	0.21%	0.47%	1.11%	1.69%
"Repayment/Forbearance Agreement"	0.02%	0.01%	0.03%	0.00%	0.00%	0.00%	0.03%	0.02%	0.04%
Total	0.41%	0.32%	0.22%	0.12%	0.10%	0.21%	0.50%	1.13%	1.73%

⁽¹⁾ As of June 30.

⁽²⁾ As of March 31, 2010.

⁽³⁾ The Department has adjusted the criteria used to identify delinquent contracts from \$25 or more delinquent to over \$3 delinquent. The data below represents the breakout of delinquent, repayment/forbearance agreements and cancelled contracts and real estate in inventory. These figures include contracts that were the subject of forbearance or repayment agreements between the Department and the contract holder.

⁽⁴⁾ Bankruptcies are included in cancelled Contracts statistics and do not exceed in any period more than 10% of total cancellations and bankruptcy category. Federal bankruptcy law precludes repossession action of Contracts of Purchase when veteran is in bankruptcy proceedings until the automatic stay is lifted.

⁽⁵⁾ Source: National Delinquency Survey published by the Mortgage Bankers Association of America (the "Survey"). For 2000, 2001 and 2002 data reported is for "Conventional Loans." In the Survey loans are categorized as prime loans or otherwise based upon the Survey respondents' internal classifications.

Distribution of Contract of Purchase Delinquencies by County⁽¹⁾

County	Total Delinquent Accounts	30 days	60 days	90+ days⁽²⁾	Total Delinquent Account Balance⁽³⁾
Riverside	123	45	12	66	\$ 31,446
Fresno	96	41	11	44	16,609
Kern	90	46	14	30	13,489
Sacramento	90	43	15	32	18,304
San Bernardino	84	42	10	32	14,431
San Diego	80	33	10	37	18,108
Los Angeles	52	31	4	17	9,763
Shasta	39	19	8	12	7,072
Placer	32	12	5	15	7,952
San Joaquin	32	21	4	7	4,865
Butte	27	13	3	11	4,867
Madera	23	10	1	12	4,019
Solano	23	9	3	11	5,658
Tulare	23	9	5	9	4,797
All Other ⁽⁴⁾	292	151	41	100	54,821
Total	1,106	525	146	435	\$ 216,201

⁽¹⁾ As of March 31, 2010.

⁽²⁾ Includes REO and canceled contracts

⁽³⁾ Amounts in thousands.

⁽⁴⁾ "All Other" counties had less than 19 delinquent contracts outstanding.

Contract of Purchase Delinquencies by Origination Date⁽¹⁾

Origination Year	30-60 days Delinquent	30-60 days Delinquent Balance⁽²⁾	60-90 days Delinquent	60-90 days Delinquent Balance⁽²⁾	90+ days Delinquent⁽³⁾	90+ days Delinquent Balance⁽²⁾⁽³⁾	Total Delinquent Contracts of Purchase	Total Delinquent Balances⁽²⁾
1998 and								
Prior	140	\$5,759	33	\$1,638	62	\$2,929	235	\$10,326
1999	20	1,911	4	659	4	646	28	3,216
2000	26	2,518	1	110	8	1,153	35	3,781
2001	12	1,449	5	625	3	376	20	2,450
2002	12	1,846	3	527	11	1,616	26	3,989
2003	49	9,146	19	3,731	34	7,370	102	20,247
2004	55	11,095	17	3,369	55	11,457	127	25,921
2005	48	10,637	13	2,460	44	10,359	105	23,456
2006	50	12,807	16	4,474	110	33,522	176	50,803
2007	56	16,420	23	6,799	74	20,966	153	44,185
2008	45	12,194	10	3,012	30	9,355	85	24,561
2009	11	2,539	2	617	--	--	13	3,156
2010	1	110	--	--	--	--	1	110
Total	525	\$88,431	146	\$28,021	435	\$99,749	1,106	\$216,201

⁽¹⁾ As of March 31, 2010.

⁽²⁾ Amounts in thousands.

⁽³⁾ Includes REO and canceled contracts.

Veterans G.O. Bonds and Revenue Bonds

The chart below sets forth certain information regarding Veterans G.O. Bonds and Revenue Bonds.

Selected Information with Respect to Veterans G.O. Bonds and Revenue Bonds							
Series	Bonds Outstanding as of March 31, 2010	Expected Bonds Outstanding as of August 1, 2010	Final Maturity Date of Series as of August 1, 2010	Next Optional Call as of August 1, 2010	Call Price on Such Date	Maximum Coupon subject to Optional Call	Bonds Subject to Special Redemption ⁽¹⁾
Veterans G.O. Bonds Issued as Qualified Veterans Mortgage Bonds under the 1954 Code							
AU	13,840,000	13,840,000	October 1, 2010	Non-callable	N.A.	N.A.	No
AV	8,980,000	8,980,000	October 1, 2010	Non-callable	N.A.	N.A.	No
Sub-total	\$ 22,820,000	\$ 22,820,000					
Veterans G.O. Bonds and Notes Issued as Qualified Veterans Mortgage Bonds under the 1986 Code							
BG/BH	\$ 74,485,000	\$ 6,105,000	December 1, 2010	Anytime	100%	5.100%	Excess Revenues
BJ7	20,000	20,000	December 1, 2010	Anytime	101%	5.375%	Excess Revenues
BJ9	1,865,000	1,865,000	December 1, 2012	Anytime	101%	5.300%	Excess Revenues
BP	2,220,000	2,220,000	December 1, 2026	Anytime	100%	5.500%	Excess Revenues
BQ/BR	48,630,000	42,040,000	December 1, 2029	Anytime	100%	5.300%	Excess Revenues
BJ11/12	11,605,000	11,605,000	December 1, 2014	December 19, 2010	101%	5.150%	Excess Revenues
BT/BU	21,265,000	12,765,000	December 1, 2011	Anytime	100%	4.900%	Excess Revenues
BV/BW	6,850,000	2,255,000	December 1, 2011	Anytime	100%	4.950%	Excess Revenues
BX	4,305,000	2,060,000	December 1, 2011	Anytime	100%	4.550%	Excess Revenues
BY/BZ	111,325,000	107,925,000	December 1, 2024	Anytime	100%	5.375%	Excess Revenues
CA/CB	221,475,000	221,475,000	December 1, 2036	June 1, 2015	100%	5.050%	Excess Revenues
CC/CD	359,160,000	359,160,000	December 1, 2040	December 1, 2015	100%	4.600%	Excess Revenues
CE	91,200,000	91,200,000	December 1, 2042	December 1, 2015	100%	5.100%	Excess Revenues
CF	0	82,725,000	December 1, 2017	N.A.	N.A.	N.A.	Excess Revenues
CG	0	25,000,000	December 1, 2018	N.A.	N.A.	N.A.	Excess Revenues
CH	0	10,985,000	December 1, 2015	N.A.	N.A.	N.A.	Excess Revenues
Sub-total	\$ 954,405,000	\$ 979,405,000					
Commercial Paper	\$ 0	\$ 0	N.A.	N.A.	N.A.	Variable	N.A.
Total Veterans G.O. Bonds	\$ 977,225,000	\$ 1,002,225,000					

Veterans Revenue Bonds

Series	Bonds Outstanding as of March 31, 2010	Expected Bonds Outstanding as of August 1, 2010	Final Maturity Date of Series as of August 1, 2010	Next Optional Call as of August 1, 2010	Call Price on Such Date	Maximum Coupon subject to Optional Call	Bonds Subject to Special Redemption ⁽¹⁾
Revenue Bonds Issued as Qualified Mortgage Bonds under the 1986 Code							
1997 C	\$ 14,830,000	\$ 14,830,000	December 1, 2013	January 9, 2011	101%	5.050%	Excess Revenues
1998 A	9,430,000	8,355,000	December 1, 2019	Anytime	100%	5.450%	Excess Revenues
2007 A	89,715,000	89,715,000	December 1, 2042	December 1, 2016	100%	5.000%	Excess Revenues/Unexpended
2007 B.....	100,000,000	100,000,000	December 1, 2037	December 1, 2016	100%	5.250%	Excess Revenues/Unexpended
Sub-total	\$ 213,975,000	\$ 212,900,000					
Revenue Bonds Issued to Refund Bonds Issued Prior to Mortgage Subsidy Bond Tax Act of 1980							
1999 A	\$ 25,160,000	\$ 25,160,000	December 1, 2027	Anytime	100%	5.200%	Excess Revenues
1999 B	43,210,000	43,210,000	December 1, 2028	Anytime	100%	5.200%	Excess Revenues
2002 A	117,200,000	117,200,000	December 1, 2027	June 1, 2012	101%	5.350%	Excess Revenues
2003 A	92,000,000	92,000,000	December 1, 2028	November 30, 2011	101%	4.600%	Excess Revenues
2005 A	42,600,000	42,600,000	December 1, 2027	June 1, 2015	100%	4.800%	Excess Revenues
2006 A.....	144,360,000	144,360,000	December 1, 2028	November 30, 2011	101%	4.600%	Excess Revenues
Sub-total	\$ 464,530,000	\$ 464,530,000					
Total Revenue Bonds	\$ 678,505,000	\$ 677,430,000					

⁽¹⁾ Excess Revenues includes principal prepayments.

Additional Investments

In addition to the investments described above under “Contracts of Purchase--Amounts Expected to be Available to Fund Contracts of Purchase and Related Investments,” the following investments have been made or will be made with respect to moneys in the 1943 Fund and in the Bond Reserve Account which secures the Revenue Bonds. Additional moneys in various Funds and Accounts in the 1943 Fund have been invested in SMIF. Amounts invested in SMIF may be withdrawn and reinvested at any time. See APPENDIX B – “THE 1943 FUND – Investments in the Surplus Money Investment Fund.”

<u>Bond Series</u>	<u>Account Designation⁽¹⁾</u>	<u>Amount (000s)</u>	<u>Investment Provider⁽¹⁾⁽¹⁴⁾</u>	<u>Initial Investment Date</u>	<u>Investment Maturity Date</u>	<u>Interest Rate (%)</u>	<u>Bond Series</u>	<u>Account Designation⁽¹⁾</u>	<u>Amount (000s)</u>	<u>Investment Provider⁽¹⁾⁽¹⁴⁾</u>	<u>Initial Investment Date</u>	<u>Investment Maturity Date</u>	<u>Interest Rate (%)</u>
1997/1998	Reserve	\$5,251 ⁽⁷⁾	Societe Generale	3/26/98	12/1/28	5.75	BJ 7/8	Revenue	Variable ⁽⁶⁾	Bayerische Landesbank Girozentrale	12/1/99	12/1/32 ⁽⁶⁾	6.06
1999 A/B	Reserve	\$9,817 ⁽⁷⁾	Westdeutsche Landesbank Girozentrale	3/30/99	12/1/28	5.38	1991 A	Revenue	Variable ⁽⁶⁾	Bayerische Landesbank Girozentrale	12/1/99	12/1/32 ⁽⁶⁾	6.06
1997 C	Reserve	\$5,733 ⁽⁷⁾	Westdeutsche Landesbank Girozentrale	1/9/01	12/1/19	5.625	BJ 9/10	Revenue/ Recycling	Variable ⁽⁸⁾	Westdeutsche Landesbank Girozentrale	4/27/00	12/1/32 ⁽⁸⁾	6.46
2002 A	Reserve	\$3,759 ⁽⁷⁾	Bayerische Landesbank Girozentrale	3/6/02	12/1/15	5.38	BS	Revenue	Variable ⁽⁸⁾	Westdeutsche Landesbank Girozentrale	4/27/00	12/1/32 ⁽⁸⁾	6.46
BG/BH/B K/BL	Revenue/ Recycling	Variable ⁽²⁾	Societe Generale	12/29/97	12/1/32	5.91	BJ 11/12	Revenue/ Recycling	Variable ⁽⁹⁾	Westdeutsche Landesbank Girozentrale	12/19/00	12/1/32 ⁽⁹⁾	5.50
1997/1998	Restricted Recoveries	Variable	Societe Generale	3/26/98	12/1/28	5.91	BT/BU	Revenue/ Recycling	Variable ⁽¹⁰⁾	Westdeutsche Landesbank Girozentrale	12/19/00	12/1/26 ⁽¹⁰⁾	5.50
BP/BN-I	Revenue/ Recycling	Variable ⁽³⁾	Westdeutsche Landesbank Girozentrale	5/5/98	12/1/28	5.38	1997 C	Revenue/ Restricted Recoveries	Variable ⁽¹¹⁾	Westdeutsche Landesbank Girozentrale	1/9/01	12/1/19	5.50
1999 A/B	Revenue/ Recycling	Variable ⁽⁴⁾	Bayerische Landesbank Girozentrale	3/30/99	12/1/28	5.30	BV/BW	Revenue/ Recycling	Variable ⁽¹²⁾	Bayerische Landesbank Girozentrale	6/20/01	12/1/32 ⁽¹²⁾	5.67
BQ/BR	Revenue/ Recycling	Variable ⁽⁵⁾	Westdeutsche Landesbank Girozentrale	4/28/99	12/1/29	5.37	BX	Revenue/ Recycling	Variable ⁽¹²⁾	Bayerische Landesbank Girozentrale	6/20/01	12/1/32 ⁽¹²⁾	5.67

⁽¹⁾ Accounts are established in the resolutions authorizing the issuance of Revenue Bonds. All investments are investment agreements unless otherwise noted.

⁽²⁾ Maximum permitted amount on deposit under investment agreement at any one time is \$250,000,000.

⁽³⁾ Maximum permitted amount on deposit under investment agreement for all (BN-I and BP) subaccounts is \$150,000,000.

⁽⁴⁾ Maximum permitted amount on deposit under investment agreement for both subaccounts is \$75,000,000.

⁽⁵⁾ Maximum permitted amount on deposit under investment agreement for both subaccounts is \$35,000,000.

⁽⁶⁾ Maximum permitted amount on deposit under investment agreement for all (BJ 7/8 and 1991 A) subaccounts is \$25,000,000. Investment maturity date for the recycling subaccounts is December 1, 2009.

⁽⁷⁾ As of June 30, 2009.

⁽⁸⁾ Maximum permitted amount on deposit under investment agreement for all three (BJ 9/10, and BS) subaccounts is \$20,000,000. Investment maturity date for BJ-9/10 G.O. Bond Series Recycling Subaccount is June 1, 2010.

⁽⁹⁾ Maximum permitted amount on deposit under investment agreement for both subaccounts is \$25,000,000. Investment maturity date for BJ-11/12 G.O. Bond Series Recycling Subaccount is December 1, 2010.

⁽¹⁰⁾ Maximum permitted amount on deposit under investment agreement for both subaccounts is \$20,000,000. Investment maturity date for BT/BU G.O. Bond Series Recycling Subaccount is December 1, 2010.

⁽¹¹⁾ Maximum permitted amount on deposit under investment agreement for both subaccounts is \$97,130,000.

⁽¹²⁾ Maximum permitted amount on deposit under investment agreement for all (BV/BW and BX) subaccounts is \$25,000,000. Investment maturity date for all (BV/BW and BX) recycling subaccounts is December 1, 2011.

⁽¹³⁾ The Department is not currently making deposits into such funds.

⁽¹⁴⁾ As of June 14, 2010 (i) Societe Generale was rated “Aa2” by Moody’s Investor Service (“Moody’s”), “A+” by Standard and Poor’s, a Division of The McGraw-Hill Companies, Inc. (“S&P”), and “A+” by Fitch Ratings (“Fitch”); (ii) Westdeutsche Landesbank Girozentrale was rated “A3” by Moody’s, “BBB+” by S&P and “A-” by Fitch; and (iii) Bayerische Landesbank Girozentrale was rated “A1” by Moody’s, is not rated by S&P and “A+” by Fitch. An explanation of the significance and status of such credit ratings may be obtained from the rating agencies furnishing the same. There is no assurance that such ratings will continue for any given period of time or that they will not be revised or withdrawn entirely by any such rating agencies if, in their respective judgments, circumstances so warrant.

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APPENDIX C

DTC AND THE BOOK-ENTRY SYSTEM

The information in the following section entitled “DTC and the Book-Entry System” has been provided by DTC for use in securities offering documents, and the State and the Department take no responsibility for the accuracy or completeness thereof. The State and the Department cannot and do not give any assurances that DTC, DTC Participants or Indirect Participants will distribute to the Beneficial Owners either (a) payments of interest, principal or redemption proceeds with respect to the Offered Veterans G.O. Bonds or (b) certificates representing ownership interest in or other confirmation of ownership interest in the Offered Veterans G.O. Bonds, or that they will so do on a timely basis or that DTC, DTC Participants or DTC Indirect Participants will act in the manner described in this Official Statement. The current “Rules” applicable to DTC are on file with the Securities and Exchange Commission and the current “Procedures” of DTC to be followed in dealing with DTC Participants are on file with DTC.

1. The Depository Trust Company (“DTC”), New York, New York, will act as securities depository for the bonds (the “Offered Veterans G.O. Bonds”). The Offered Veterans G.O. Bonds will be issued as fully-registered securities registered in the name of Cede & Co. (DTC’s partnership nominee) or such other name as may be requested by an authorized representative of DTC. One fully-registered Offered Veterans G.O. Bond certificate will be issued for each maturity of the Offered Veterans G.O. Bonds, each in the aggregate principal amount of such maturity, and will be deposited with DTC. If, however, the aggregate principal amount of any maturity exceeds \$500 million, one certificate will be issued with respect to each \$500 million of principal amount and an additional certificate will be issued with respect to any remaining principal amount of such issue.

2. DTC, the world’s largest securities depository, is a limited-purpose trust company organized under the New York Banking Law, a “banking organization” within the meaning of the New York Banking Law, a member of the Federal Reserve System, a “clearing corporation” within the meaning of the New York Uniform Commercial Code, and a “clearing agency” registered pursuant to the provisions of Section 17A of the Securities Exchange Act of 1934. DTC holds and provides asset servicing for over 3.5 million issues of U.S. and non-U.S. equity issues, corporate and municipal debt issues, and money market instruments (from over 100 countries) that DTC’s participants (“Direct Participants”) deposit with DTC. DTC also facilitates the post-trade settlement among Direct Participants of sales and other securities transactions in deposited securities, through electronic computerized book-entry transfers and pledges between Direct Participants’ accounts. This eliminates the need for physical movement of securities certificates. Direct Participants include both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, clearing corporations, and certain other organizations. DTC is a wholly-owned subsidiary of The Depository Trust & Clearing Corporation (“DTCC”). DTCC is the holding company for DTC, National Securities Clearing Corporation and Fixed Income Clearing Corporation, all of which are registered clearing agencies. DTCC is owned by the users of its regulated subsidiaries. Access to the DTC system is also available to others such as both U.S. and non-U.S. securities brokers and dealers, banks, trust companies, and clearing corporations that clear through or maintain a custodial relationship with a Direct Participant, either directly or indirectly (“Indirect Participants”). DTC has Standard & Poor’s highest rating: AAA. The DTC Rules applicable to its Participants are on file with the Securities and Exchange

Commission. More information about DTC can be found at www.dtcc.com and www.dtc.org. Nothing contained on such web site is incorporated herein.

3. Purchases of Offered Veterans G.O. Bonds under the DTC system must be made by or through Direct Participants, which will receive a credit for the Offered Veterans G.O. Bonds on DTC's records. The ownership interest of each actual purchaser of each Offered Veterans G.O. Bond ("Beneficial Owner") is in turn to be recorded on the Direct and Indirect Participants' records. Beneficial Owners will not receive written confirmation from DTC of their purchase. Beneficial Owners are, however, expected to receive written confirmations providing details of the transaction, as well as periodic statements of their holdings, from the Direct or Indirect Participant through which the Beneficial Owner entered into the transaction. Transfers of ownership interests in the Offered Veterans G.O. Bonds are to be accomplished by entries made on the books of Direct and Indirect Participants acting on behalf of Beneficial Owners. Beneficial Owners will not receive certificates representing their ownership interests in the Offered Veterans G.O. Bonds, except in the event that use of the book-entry system for the Offered Veterans G.O. Bonds is discontinued.

4. To facilitate subsequent transfers, all Offered Veterans G.O. Bonds deposited by Direct Participants with DTC are registered in the name of DTC's partnership nominee, Cede & Co., or such other name as may be requested by an authorized representative of DTC. The deposit of Offered Veterans G.O. Bonds with DTC and their registration in the name of Cede & Co. or such other nominee do not effect any change in beneficial ownership. DTC has no knowledge of the actual Beneficial Owners of the Offered Veterans G.O. Bonds. DTC's records reflect only the identity of the Direct Participants to whose accounts such Offered Veterans G.O. Bonds are credited, which may or may not be the Beneficial Owners. The Direct and Indirect Participants will remain responsible for keeping account of their holdings on behalf of their customers.

5. Conveyance of notices and other communications by DTC to Direct Participants, by Direct Participants to Indirect Participants, and by Direct Participants and Indirect Participants to Beneficial Owners will be governed by arrangements among them, subject to any statutory or regulatory requirements as may be in effect from time to time. The State Treasurer will not have any responsibility or obligation to such Direct Participants and Indirect Participants or the persons for whom they act as nominees with respect to the Offered Veterans G.O. Bonds.

6. Beneficial Owners of Offered Veterans G.O. Bonds may wish to take certain steps to augment the transmission to them of notices of significant events with respect to the Offered Veterans G.O. Bonds, such as redemptions, tenders, defaults, and proposed amendments to the Offered Veterans G.O. Bond documents. For example, Beneficial Owners of Offered Veterans G.O. Bonds may wish to ascertain that the nominee holding the Offered Veterans G.O. Bonds for their benefit has agreed to obtain and transmit notices to Beneficial Owners. In the alternative, Beneficial Owners may wish to provide their names and addresses to the registrar and request that copies of notices be provided directly to them.

7. Redemption notices shall be sent to DTC. If less than all of a maturity of the Offered Veterans G.O. Bonds, within a maturity are being redeemed, DTC's practice is to determine by lot the amount of the interest of each Direct Participant in such maturity to be redeemed.

8. Neither DTC nor Cede & Co. (nor such other DTC nominee) will consent or vote with respect to the Offered Veterans G.O. Bonds unless authorized by a Direct Participant in accordance with DTC's Procedures. Under its usual procedures, DTC mails an Omnibus Proxy to the State Treasurer as soon as possible after the record date. The Omnibus Proxy assigns Cede & Co.'s consenting or voting rights to those Direct Participants to whose accounts the Offered Veterans G.O. Bonds are credited on the record date (identified in a listing attached to the Omnibus Proxy).

9. Without limiting the generality of the foregoing, the State Treasurer and the Department have no responsibility or liability for any aspects of the records relating to or payments made on account of beneficial ownership, or for maintaining, supervising or reviewing any records relating to beneficial ownership or interests in the Offered Veterans G.O. Bonds.

10. Principal, interest payments and redemption proceeds on the Offered Veterans G.O. Bonds will be made to Cede & Co., or such other nominee as may be requested by an authorized representative of DTC. DTC's practice is to credit Direct Participants' accounts upon DTC's receipt of funds and corresponding detail information from the State Treasurer, on payable dates in accordance with their respective holdings shown on DTC's records. Payments by Direct Participants and Indirect Participants to Beneficial Owners will be governed by standing instructions and customary practices, as is the case with securities held for the accounts of customers in bearer form or registered in "street name," and will be the responsibility of such Participant and not of DTC nor its nominee or the State Treasurer or the Department, subject to any statutory, or regulatory requirements as may be in effect from time to time. Payment of principal, interest and redemption proceeds, if any, to Cede & Co. (or such other nominee as may be requested by an authorized representative of DTC) is the responsibility of the State Treasurer or the Department, disbursement of such payments to Direct Participants will be the responsibility of DTC, and disbursement of such payments to the Beneficial Owners will be the responsibility of Direct Participants and Indirect Participants.

11. DTC may discontinue providing its services as depository with respect to the Offered Veterans G.O. Bonds at any time by giving reasonable notice to the State Treasurer. Under such circumstances, in the event that a successor depository is not obtained, Offered Veterans G.O. Bond certificates are required to be printed and delivered.

12. The State Treasurer and the Department cannot and do not give any assurances that DTC, Direct Participants, Indirect Participants or others will distribute payments with respect to the Offered Veterans G.O. Bonds received by DTC or its nominee as the registered owner, or any redemption or other notices to the Beneficial Owners, or that they will do so on a timely basis or that DTC will serve and act in the manner described in this Official Statement.

13. The State Treasurer may decide to discontinue use of the system of book-entry-only transfers through DTC (or a successor securities depository). If the State Treasurer determines not to continue the DTC book-entry only system, or DTC discontinues providing its services with respect to the Offered Veterans G.O. Bonds and the State Treasurer does not select another qualified securities depository, the State Treasurer shall deliver physical Offered Veterans G.O. Bond certificates to the Beneficial Owners. The Offered Veterans G.O. Bonds may thereafter be transferred upon the books of the State Treasurer by the registered owners, in person or by authorized attorney, upon surrender of Offered Veterans G.O. Bonds at the Office of the State Treasurer in Sacramento, California, accompanied by delivery of an executed

instrument of transfer in a form approved by the State Treasurer and upon payment of any charges provided for in the Resolutions. Certificated Offered Veterans G.O. Bonds may be exchanged for Offered Veterans G.O. Bonds of other authorized denominations of the same aggregate principal amount and maturity at the Office of the State Treasurer in Sacramento, California, upon payment of any charges provided for in the Resolutions. No transfer or exchange of Offered Veterans G.O. Bonds will be made by the State Treasurer during the period between the record date and the next Interest Payment Date.

THE STATE TREASURER, AS LONG AS A BOOK-ENTRY ONLY SYSTEM IS USED FOR THE OFFERED VETERANS G.O. BONDS, WILL SEND ANY NOTICE OF REDEMPTION OR OTHER NOTICES TO OWNERS TO ONLY DTC. ANY FAILURE OF DTC TO ADVISE ANY DTC PARTICIPANT, OR OF ANY DTC PARTICIPANT TO NOTIFY ANY BENEFICIAL OWNER, OF ANY NOTICE AND ITS CONTENT OR EFFECT WILL NOT AFFECT THE VALIDITY OR SUFFICIENCY OF THE PROCEEDINGS RELATING TO THE REDEMPTION OF THE OFFERED VETERANS G.O. BONDS CALLED FOR REDEMPTION OR OF ANY OTHER ACTION PREMISED ON SUCH NOTICE.

14. The foregoing description of the procedures and record keeping with respect to beneficial ownership interests in the Offered Veterans G.O. Bonds, payment of principal of and interest and other payments with respect to the Offered Veterans G.O. Bonds to Direct Participants, Indirect Participants or Beneficial Owners, confirmation and transfer of beneficial ownership interest in such Offered Veterans G.O. Bonds and other related transactions by and between DTC, the Direct Participants, the Indirect Participants and the Beneficial Owners is based solely on information provided by DTC. Accordingly, no representations can be made concerning these matters and neither the Direct Participants, the Indirect Participants nor the Beneficial Owners should rely on the foregoing information with respect to such matters but should instead confirm the same with DTC or the Participants, as the case may be.

SO LONG AS CEDE & CO. IS THE REGISTERED OWNER OF THE OFFERED VETERANS G.O. BONDS, AS NOMINEE OF DTC, REFERENCES HEREIN TO THE HOLDERS OF THE OFFERED VETERANS G.O. BONDS (OTHER THAN UNDER THE CAPTION "TAX MATTERS" HEREIN) SHALL MEAN CEDE & CO., AS AFORESAID, AND SHALL NOT MEAN THE BENEFICIAL OWNERS OF THE OFFERED VETERANS G.O. BONDS.

According to DTC, the foregoing information with respect to DTC has been provided for informational purposes only and is not intended to serve as a representation, warranty or contract modification of any kind.

APPENDIX D
SUMMARY OF CONTINUING DISCLOSURE CERTIFICATES

STATE TREASURER'S DISCLOSURE CERTIFICATE

The State Treasurer, on behalf of the State, executed a Continuing Disclosure Certificate (the "Treasurer's Disclosure Certificate") for the Offered Veterans G.O. Bonds. The following is a summary of the provisions of the Treasurer's Disclosure Certificate. Such summary is qualified by reference to the complete Treasurer's Disclosure Certificate, which is available from the Office of the State Treasurer.

Nature of the Disclosure Certificate

The Treasurer's Disclosure Certificate is executed for the benefit of the Holders and Beneficial Owners (as defined below) of the Offered Veterans G.O. Bonds from time to time, and in order to assist the Participating Underwriters (as defined below) in complying with the Rule (as defined below), but shall not be deemed to create any monetary liability on the part of the State or the State Treasurer to any other persons, including Holders or Beneficial Owners of the Bonds based on the Rule. The sole remedy in the event of any failure of the State Treasurer to comply with the Treasurer's Disclosure Certificate shall be an action to compel performance of any act required thereunder.

Definitions

Defined terms used in the Treasurer's Disclosure Certificate and not otherwise defined therein have the meanings set forth elsewhere in this Official Statement:

"Annual Report" shall mean the Annual Report filed by the State Treasurer pursuant to, and as described in, the Treasurer's Disclosure Certificate.

"Beneficial Owner" shall mean any person who has or shares the power, directly or indirectly, to make investment decisions concerning ownership of Offered Veterans G.O. Bonds (including persons holding Offered Veterans G.O. Bonds through nominees, depositories or other intermediaries).

"Dissemination Agent" shall mean the State Treasurer, acting in its capacity as Dissemination Agent under the Treasurer's Disclosure Certificate, or any successor Dissemination Agent designated in writing by the State Treasurer.

"Holder" shall mean any person listed on the registration books of the State Treasurer as the registered owner of Offered Veterans G.O. Bonds.

"Listed Events" shall mean any of the events listed below under "Reporting of Significant Events."

"MSRB" shall mean the Municipal Securities Rulemaking Board or any other entity designated or authorized by the SEC to receive reports or notices pursuant to the Rule. Until otherwise designated by the MSRB or the SEC, filings with the MSRB are to be made through the Electronic Municipal Market Access (EMMA) website of the MSRB, currently located at <http://emma.msrb.org>.

"Official Statement" shall mean the Official Statement relating to the Offered Veterans G.O. Bonds.

“Participating Underwriter” shall mean any original underwriters of the Offered Veterans G.O. Bonds required to comply with the Rule in connection with the offering of the Offered Veterans G.O. Bonds.

“Rule” shall mean Rule 15c2-12(b)(5) adopted by the SEC under the Securities Exchange Act of 1934, as the same may be amended from time to time.

“SEC” shall mean the United States Securities and Exchange Commission.

“State” shall mean the State of California.

Provision of Annual Reports

The State Treasurer on behalf of the State shall, not later than April 1 of each year in which the Offered Veterans G.O. Bonds are outstanding, commencing with the report containing 2009-10 Fiscal Year financial information, provide an Annual Report consistent with the requirements of the Treasurer’s Disclosure Certificate (an “Annual Report”) to the MSRB in such form as is required by the MSRB; provided that the audited financial statements of the State may be submitted separately from the balance of the Annual Report and later than the date required above for the filing of the Annual Report if they are not available by that date. The State Treasurer shall make a copy of any Annual Report available to any person who requests a copy at a cost not exceeding the reasonable cost of duplication and delivery.

If in any year, the State Treasurer does not provide the Annual Report to the MSRB by the time specified above, the State Treasurer shall instead file a notice with the MSRB stating that the Annual Report has not been timely completed and, if known, stating the date by which the State Treasurer expects to file the Annual Report.

If the Dissemination Agent is not the State Treasurer, the Dissemination Agent shall: (i) if an entity other than the MSRB has been designated by the SEC to receive reports or notices pursuant to the Rule, determine prior to the date for filing the Annual Report the name and address of such entity; (ii) file a report with the State Treasurer certifying that the Annual Report has been filed pursuant to Treasurer’s Disclosure Certificate and the dates of the filings (and if an entity other than the MSRB has been designated by the SEC to receive reports or notices pursuant to the Rule, specifying the name and address of such entity); and (iii) take any other actions mutually agreed to between the Dissemination Agent and the State Treasurer.

Content of Annual Reports

The Annual Report shall contain or include by reference the following:

(1) The audited Basic Financial Statements of the State for the fiscal year ended on the previous June 30, prepared in accordance with generally accepted accounting principles promulgated to apply to government entities from time to time by the Governmental Accounting Standards Board. If the State’s audited financial statements are not available by the time the Annual Report is required to be filed pursuant to the Treasurer’s Disclosure Certificate, the Annual Report shall contain unaudited financial statements in a format similar to the financial statements contained in the final Official Statement, and the audited financial statements shall be filed in the same manner as the Annual Report when they become available.

(2) Financial information relating to the State’s General Fund budget for the fiscal year ended on the previous June 30 and information concerning the State budget for the fiscal year in which the Annual Report is issued. Such information shall describe the sources of revenues, the

principal categories of expenditures, and changes in fund balances, a summary of expected State revenues and budgeted expenditures, and significant assumptions relating to revenue and expenditure expectations; including updating the following tables which appear under the caption APPENDIX A – “THE STATE OF CALIFORNIA – 2010-11 PROPOSED GOVERNOR’S BUDGET AND THE 2010-11 MAY REVISION” in the Official Statement:

Tables Entitled

Statement of Estimated Revenues, Expenditures and Changes in Fund Balance – General Fund

General Fund Revenue Sources and Expenditures

(3) Information concerning the total amount of the State’s authorized and outstanding debt, long-term lease obligations and other long-term liabilities as of the end of the most recent June 30, which debt is supported by payments from the State’s General Fund and which includes short-term debt. Such information shall include schedules of debt service for outstanding general obligation bonds and lease-purchase debt. This shall be accomplished by updating the following tables which appear under the caption APPENDIX A – “THE STATE OF CALIFORNIA – STATE DEBT TABLES” in the Official Statement:

Tables Entitled

Outstanding State Debt

Authorized and Outstanding General Obligation Bonds

General Obligation and Lease Revenue Bonds – Summary of Debt Service Requirements

Schedule of Debt Service Requirements for General Fund – Non-Self Liquidating Bonds – Fixed Rate

Schedule of Debt Service Requirements for General Fund – Non-Self Liquidating Bonds – Variable Rate

Schedule of Debt Service Requirements for Special Revenue Fund – Self Liquidating Bonds – Fixed Rate

Schedule of Debt Service Requirements for Special Revenue Fund – Self Liquidating Bonds – Variable Rate

Schedule of Debt Service Requirements for Enterprise Fund – Self Liquidating Bonds – Fixed Rate

Schedule of Debt Service Requirements for Lease-Purchase Debt

State Public Works Board and Other Lease-Purchase Financing Outstanding Issues

State Agency Revenue Bonds and Conduit Financing

The Annual Report may consist of one or more documents. Any or all of the items listed above may be included in the Annual Report by reference to other documents that have been filed by the State with the MSRB, including any final official statement (in which case such final official statement must also be available from the MSRB). The State Treasurer shall clearly identify in the Annual Report each such document so included by reference.

Reporting of Significant Events

The State Treasurer, on behalf of the State shall give, or cause to be given, prompt notice of the occurrence of any of the following events with respect to the Offered Veterans G.O. Bonds, if material:

1. principal and interest payment delinquencies;
2. non-payment related defaults;
3. modifications to rights of Bondholders;
4. optional, contingent or unscheduled bond calls;
5. defeasances;
6. rating changes;
7. adverse tax opinions or events affecting the tax-exempt status of the Offered Veterans G.O. Bonds;
8. unscheduled draws on debt service reserves reflecting financial difficulties;
9. unscheduled draws on credit enhancements reflecting financial difficulties;
10. substitution of credit or liquidity providers, or their failure to perform; or
11. release, substitution or sale of property securing repayment of the Offered Veterans G.O. Bonds.

The State Treasurer shall timely file a notice of the occurrence of a Listed Event, which is material under applicable federal securities laws, with the MSRB, in the form required by the MSRB. The State notes that items 8, 9, 10 and 11 above are not applicable to the Offered Veterans G.O. Bonds.

Other Provisions

Termination of Reporting Obligation. The State's obligations under the Treasurer's Disclosure Certificate shall terminate upon the maturity, legal defeasance, prior redemption or acceleration of all of the outstanding Offered Veterans G.O. Bonds or if less than all of the Offered Veterans G.O. Bonds are defeased, with respect to those Offered Veterans G.O. Bonds, so defeased. If such termination occurs prior to the final maturity of the Offered Veterans G.O. Bonds, the State Treasurer shall give notice of such termination in the same manner as for a Listed Event.

Dissemination Agent. The State Treasurer may, from time to time, appoint or engage a Dissemination Agent to assist it in carrying out the obligations under the Treasurer's Disclosure Certificate, and may discharge any such Dissemination Agent, with or without appointing a successor Dissemination Agent. The Dissemination Agent shall not be responsible in any manner for the content of any notice or report prepared by the State Treasurer pursuant to Treasurer's Disclosure Certificate. If at any time there is not any other designated Dissemination Agent, the State Treasurer shall be the Dissemination Agent. The initial Dissemination Agent shall be the State Treasurer.

Amendment; Waiver. Notwithstanding any other provision of the Treasurer's Disclosure Certificate, the State Treasurer may amend or waive any provision of the Treasurer's Disclosure Certificate, provided that the following conditions are satisfied:

- (a) If the amendment or waiver relates to the provisions of the Treasurer's Disclosure Certificate dealing with the timing or content of the Annual Report or the giving of notice of Listed Events, it may only be made in connection with a change in circumstances that arises from a change

in legal requirements, change in law or change in the identity, nature or status of an obligated person with respect to Offered Veterans G.O. Bonds, or the type of business conducted;

(b) The undertaking, as amended or taking into account such waiver, would, in the opinion of nationally recognized bond counsel, have complied with the requirements of the Rule at the time of the original issuance of Offered Veterans G.O. Bonds, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances; and

(c) The amendment or waiver either (i) is approved by the Holders of sixty percent (60%) of Offered Veterans G.O. Bonds outstanding, or (ii) does not, in the opinion of nationally recognized bond counsel, materially impair the interests of the Holders or Beneficial Owners of Offered Veterans G.O. Bonds. The State also may amend this Disclosure Certificate without approval by the Holders to the extent permitted by rule, order or other official pronouncement of the SEC.

In the event of any amendment or waiver of a provision of the Treasurer's Disclosure Certificate, the State Treasurer shall describe such amendment in the next Annual Report, and shall include, as applicable, a narrative explanation of the reason for the amendment or waiver and its impact on the type (or, in the case of a change of accounting principles, on the presentation) of financial information or operating data being presented by the State. In addition, if the amendment relates to the accounting principles to be followed in preparing financial statements, (i) notice of such change shall be given in the same manner as for a Listed Event, and (ii) the Annual Report for the year in which the change is made should present a comparison (in narrative form and also, if feasible, in quantitative form) between the financial statements as prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles.

Additional Information. Nothing in the Treasurer's Disclosure Certificate shall be deemed to prevent the State Treasurer from disseminating any other information, using the means of dissemination set forth in the Treasurer's Disclosure Certificate or any other means of communication, or including any other information in any Annual Report or notice of occurrence of a Listed Event, in addition to that which is required by the Treasurer's Disclosure Certificate. If the State Treasurer chooses to include any information in any Annual Report or notice of occurrence of a Listed Event in addition to that which is specifically required by the Treasurer's Disclosure Certificate, the State Treasurer shall not have any obligation to update such information or include it in any future Annual Report or notice of occurrence of a Listed Event.

Beneficiaries. The Treasurer's Disclosure Certificate shall inure solely to the benefit of the Holders and Beneficial Owners from time to time of Offered Veterans G.O. Bonds, and shall create no rights in any other person or entity (except the right of the Dissemination Agent or any Holder or Beneficial Owner to enforce the provisions of the Treasurer's Disclosure Certificate on behalf of the Holders). The Treasurer's Disclosure Certificate is not intended to create any monetary rights on behalf of any person based upon the Rule.

Partial Invalidity. If any one or more of the agreements or covenants or portions of the Treasurer's Disclosure Certificate required by the Treasurer's Disclosure Certificate to be performed by or on the part of the State Treasurer shall be contrary to law, then such agreement or agreements, such covenant or covenants or such portions of the Treasurer's Disclosure Certificate shall be null and void and shall be deemed separable from the remaining agreements and covenants or portions of the Treasurer's Disclosure Certificate and shall in no way affect the validity of the Treasurer's Disclosure Certificate, and the Holders of the Offered Veterans G.O. Bonds shall retain all the benefits afforded to them under the Treasurer's Disclosure Certificate.

The State Treasurer hereby declares that he would have executed and delivered the Treasurer's Disclosure Certificate and each and every other article, section, paragraph, subdivision, sentence, clause and phrase of the Treasurer's Disclosure Certificate irrespective of the fact that any one or more articles, sections, paragraphs, subdivisions, sentences, clauses or phrases of the Treasurer's Disclosure Certificate or the application of the Treasurer's Disclosure Certificate to any person or circumstance may be held to be unconstitutional, unenforceable or invalid.

Governing Law. The laws of the State of California shall govern this Disclosure Certificate, the interpretation thereof and any right or liability arising under the Treasurer's Disclosure Certificate. Any action or proceeding to enforce or interpret any provision of the Treasurer's Disclosure Certificate shall be brought, commenced or prosecuted in any court of the State located in Sacramento County, California.

DEPARTMENT'S DISCLOSURE CERTIFICATE

The Secretary of Veterans Affairs (the "Secretary"), on behalf of the Department, executed a Continuing Disclosure Certificate (the "Department's Disclosure Certificate") for the Offered Veterans G.O. Bonds. The following is a summary of the Department's Disclosure Certificate. Such summary is qualified by reference to the complete Department's Disclosure Certificate, which are available from the Department.

The Department's Disclosure Certificate is executed for the benefit of the Holders and Beneficial Owners (as defined below) of the Subject Bonds (as defined below) from time to time, and in order to assist the Underwriters (as defined below) in complying with the Rule (as defined below), but shall not be deemed to create any monetary liability on the part of the State (as defined below), the State Treasurer (as defined below) or the Department to any other persons, including Holders or Beneficial Owners of the Subject Bonds based on the Rule. The sole remedy in the event of any failure of the State Treasurer or the Department to comply with the Department's Disclosure Certificate shall be an action to compel performance of any act required hereunder

Certain Definitions

Defined terms used in the Department's Disclosure Certificate and not otherwise defined therein have the meanings set forth in the Official Statement.

"Annual Financial Information" means, collectively, (1) financial information or operating data applicable to the Department's most recent Fiscal Year on and after the fiscal year ending on or after June 30, 2010 of the types included in this Official Statement in Exhibit 2 to Appendix B thereto, and (2) the information regarding amendments to the Department's Disclosure Certificate required pursuant to the Department's Disclosure Certificate. Annual Financial Information shall include Audited Financial Statements, if available, or Unaudited Financial Statements.

"Audited Financial Statements" means annual financial statements, if any, of the 1943 Fund, audited by such auditor as shall then be required or permitted by State law. Audited Financial Statements shall be prepared in accordance with GAAP applied on a consistent basis; *provided, however*, that the Department may from time to time, in order to comply with federal or State legal requirements, modify the basis upon which its financial statements are prepared. Notice of any such modification shall be provided to (i) the State Treasurer and (ii) the MSRB and shall include a reference to the specific federal or State law or regulation describing such accounting basis.

"Beneficial Owner" means any person who has or shares the power, directly or indirectly, to make investment decisions concerning ownership of any Subject Bonds (including persons holding Subject Bonds through nominees, depositories or other intermediaries).

"Bonds" means, at any time, all of the State's then outstanding Offered Veterans G.O. Bonds, collectively.

"Fiscal Year" means that period established by the Department with respect to which its, as applicable, Audited Financial Statements or Unaudited Financial Statements are prepared. As of the date of the Department's Disclosure Certificate, the Department's Fiscal Year begins on July 1 and ends on June 30 of the next calendar year.

“GAAP” means generally accepted accounting principles as prescribed from time to time by the Financial Accounting Standards Board.

“Holder” means any person listed on the registration books of the State Treasurer as the registered owner of any Subject Bonds.

“MSRB” means the Municipal Securities Rulemaking Board or any other entity designated or authorized by the SEC to receive reports or notices pursuant to the Rule. Until otherwise designated by the MSRB or the SEC, filings with the MSRB are to be made through the Electronic Municipal Market Access (EMMA) website of the MSRB, currently located at <http://emma.msrb.org>.

“Notice” means written notice, sent for overnight delivery via the United States Postal Service or a private delivery service which provides evidence of delivery.

“Official Statement” means the Official Statement relating to the Subject Bonds.

“Rule” means Rule 15c2-12(b)(5) adopted by the SEC under the Securities Exchange Act of 1934, as the same may be amended from time to time.

“SEC” means the United States Securities and Exchange Commission.

“Securities Counsel” means legal counsel expert in federal securities law.

“State” means the State of California.

“State Treasurer” means the Treasurer of the State of California.

“Subject Bonds” means the Offered Veterans G.O. Bonds.

“Unaudited Financial Statements” means the same as Audited Financial Statements, except that they shall not have been audited.

“Underwriters” means any original underwriters of the Offered Veterans G.O. Bonds required to comply with the Rule in connection with the offering of the Offered Veterans G.O. Bonds.

Provision of Annual Financial Information

The Department shall provide Annual Financial Information with respect to each Fiscal Year to the State Treasurer and to the MSRB in the form required by the MSRB by no later than April 1 of each year the Subject Bonds are outstanding.

The Department’s Disclosure Certificate requires the Department to provide, in a timely manner, notice of any failure by it to provide Annual Financial Information to the MSRB and the State Treasurer on or before the date described in the first paragraph under this heading, to the State Treasurer and to the MSRB.

If not provided as part of the Annual Financial Information by the date required, the Department shall provide Audited Financial Statements, when and if available, to the State Treasurer and to the MSRB.

Additional Disclosure Obligations

The Department acknowledges in the Department’s Disclosure Certificate that other state and federal laws, including but not limited to the Securities Act of 1933 and Rule 10b-5

promulgated under the Securities Exchange Act of 1934, may apply to the Department, and that under some circumstances compliance with the Department's Disclosure Certificate, without additional disclosures or other action, may not fully discharge all duties and obligations of the Department under such laws.

Additional Information

Nothing in the Department's Disclosure Certificate will be deemed to prevent the Department from disseminating any other information, using the means of dissemination set forth in such Department's Disclosure Certificate or any other means of communication, or including any other information in any Annual Financial Information, in addition to that which is required by the Department's Disclosure Certificate. If the Department chooses to include any information in any Annual Financial Information in addition to that which is specifically required by the Department's Disclosure Certificate, the Department shall have no obligation under the Department's Disclosure Certificate to update such information or include it in any future Annual Financial Information.

Operating Rules

Annual Financial Information shall be provided at least annually, notwithstanding any Fiscal Year longer than 12 calendar months. The Department shall promptly notify the State Treasurer and the MSRB, of any change in its Fiscal Year. It shall be sufficient for purposes of the Department's Disclosure Certificate if the Department provides Annual Financial Information by specific reference to documents previously either (i) provided to the MSRB or (ii) filed with the SEC. If such a document is a final official statement within the meaning of the Rule, it must be available from the MSRB. Annual Financial Information may be provided in one document or multiple documents, and at one time or in part from time to time. Unless otherwise required by law and, in the Department's sole determination, subject to technical and economic feasibility, the Department shall employ such methods of information and notice transmission as shall be required, requested or recommended by the herein-designated recipients of the Department's information and notices.

Termination of Reporting Obligation

The Department's obligations under the Department's Disclosure Certificate with respect to the Subject Bonds terminate upon the legal defeasance, prior redemption, or payment in full of all of such Subject Bonds or if less than all of the Subject Bonds are defeased, with respect to those Subject Bonds, so defeased. If such termination occurs prior to the final maturity of the Subject Bonds, the Department shall give notice of such termination to the State Treasurer and the MSRB.

Department's Disclosure Certificate, or any provision thereof, shall be null and void to the extent set forth in an opinion of Securities Counsel obtained by the Department, and addressed to the Department and the State Treasurer, to the effect that those portions of the Rule which require the provisions of the Department's Disclosure Certificate, or any of such provisions, do not or no longer apply to any or all of the Subject Bonds, whether because such portions of the Rule are invalid, have been repealed, or otherwise, as shall be specified in such opinion, and delivers notice to such effect to the State Treasurer and to the MSRB.

Amendment of Department's Disclosure Certificate

The Department's Disclosure Certificate may be amended and any provision of the Department's Disclosure Certificate may be waived, without the consent of the Holders or

Beneficial Owners, except as described in clause 4(ii) below, under the following conditions: (1) such amendment or waiver is made in connection with a change in circumstances that arises from a change in legal (including regulatory) requirements, a change in law (including rules or regulations) or in interpretations thereof, or a change in the identity, nature or status of the Department or the type of business conducted thereby, (2) the Department's Disclosure Certificate as so amended or waived would have complied with the requirements of the Rule as of the date of the primary offering of the Subject Bonds affected by such amendment or waiver, after taking into account any amendments or interpretations of the Rule, as well as any change in circumstances, (3) the Department shall have obtained an opinion of Securities Counsel, addressed to the Department and the State Treasurer, to the same effect as set forth in clause (2) above, (4) either (i) a party unaffiliated with the Department (such as bond counsel), acceptable to the Department, has determined that the amendment or waiver does not materially impair the interests of the Beneficial Owners, or (ii) the applicable Holders of 60% of the Subject Bonds outstanding consent to the amendment to or waiver of such Department's Disclosure Certificate, and (5) the Department shall have delivered copies of such amendment or waiver to the State Treasurer and to the MSRB.

In addition to the foregoing, the Department may amend the Department's Disclosure Certificate, and any provision of the Department's Disclosure Certificate may be waived, if (i) the Department shall have received an opinion of Securities Counsel, addressed to the Department and the State Treasurer, to the effect that the adoption and the terms of the amendment or waiver would not, in and of themselves, cause the undertakings in such Department's Disclosure Certificate to violate the Rule, taking into account any subsequent change in or official interpretation of the Rule or (ii) to the extent permitted by rule, order or official pronouncement of the SEC.

To the extent any amendment to the Department's Disclosure Certificate results in a change in the type of financial information or operating data provided pursuant to the Department's Disclosure Certificate, the first Annual Financial Information provided thereafter shall include a narrative explanation of the reasons for the amendment, and the impact of the change.

If a change is made to the basis on which financial statements are prepared, the Annual Financial Information for the year in which the change is made shall present a comparison between the financial statements or information prepared on the basis of the new accounting principles and those prepared on the basis of the former accounting principles. Such comparison shall include a qualitative and, to the extent reasonably feasible, quantitative discussion of the differences in the accounting principles and the impact of the change in the accounting principles on the presentation of the financial information.

Benefit; Third-Party Beneficiaries; Enforcement

The provisions of the Department's Disclosure Certificate shall inure solely to the benefit of the Holders from time to time; except that Beneficial Owners shall be third-party beneficiaries of the Department's Disclosure Certificate.

Except as described in this paragraph, the provisions of the Department's Disclosure Certificate shall create no rights in any other person or entity. Except as limited by the succeeding sentence, the obligation of the Department to comply with the provisions of the Department's Disclosure Certificate shall be enforceable (i) in the case of enforcement of obligations to provide financial statements, financial information, operating data, and notices, by

any Beneficial Owner of outstanding Subject Bonds, or (ii) in the case of challenges to the adequacy of the financial statements, financial information and operating data so provided, by the Holder of not less than 25% in aggregate principal amount of the Subject Bonds at the time outstanding.

The right to enforce the provisions of the Department's Disclosure Certificate shall be limited to a right, by action in mandamus or for specific performance, to compel performance of the Department's obligations under the Department's Disclosure Certificate. Any failure by the Department to perform in accordance with the Department's Disclosure Certificate shall not constitute a default or any Event of Default under the Subject Bonds, and the rights and remedies provided by the Subject Bonds upon the occurrence of a default or an Event of Default shall not apply to any such failure.

Governing Law

The laws of the State shall govern the Department's Disclosure Certificate, the interpretation thereof and any right or liability arising hereunder. Any action or proceeding to enforce or interpret any provision of the Department's Disclosure Certificate shall be brought, commenced or prosecuted in any court of the State located in Sacramento County, California.

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APPENDIX E

CERTAIN FEDERAL TAX CODE REQUIREMENTS

The Federal Tax Code substantially restricts the use of proceeds of tax-exempt obligations used to finance mortgage loans for single family housing or to refund such obligations.

Those Federal Tax Code restrictions are not the same for all such tax-exempt bonds. There are three types of such tax-exempt bonds: (i) qualified mortgage bonds, which provide QMB Proceeds, (ii) qualified veterans' mortgage bonds, which provide QVMB Proceeds, and (iii) Pre-Ullman bonds, which provide Pre-Ullman Moneys. Revenue Bonds may be either qualified mortgage bonds or Pre-Ullman bonds. ("Pre-Ullman bonds" are bonds issued before 1981, or bonds issued to refund such bonds.) Veterans G.O. Bonds may be either qualified veterans' mortgage bonds or Pre-Ullman bonds. The principal Federal Tax Code restrictions relate to: (i) the use of proceeds of the bond issue, (ii) the yield on the financed mortgage loans and from certain non-mortgage investments related to the issue, (iii) for qualified mortgage bonds and qualified veterans' mortgage bonds, loan eligibility requirements, (iv) for qualified mortgage bonds, the availability of proceeds of the issue for financing housing located in "targeted areas," and (v) certain matters relating to the issue itself.

See "TAX MATTERS" for information regarding the requirements applicable to the Offered Veterans G.O. Bonds.

Failure to comply with the applicable provisions of the Federal Tax Code may result in interest on the applicable issue of bonds being included in gross income for federal income tax purposes retroactive to the date of issuance thereof.

Loan Eligibility Requirements Imposed by the Federal Tax Code on QMB Proceeds and QVMB Proceeds

QMB Proceeds

The Federal Tax Code contains the following loan eligibility requirements with respect to QMB Proceeds, except as described below under "Refinancing of Qualified Subprime Loans under the 2008 Housing Act," and except that the requirements described under "First-Time Homebuyer Requirement," "Purchase Price Limitation," and "Other Requirements Imposed by the Code – Recapture Provision Applicable to Qualified Mortgage Bonds" do not apply to home improvement loans, and the requirements described under "Qualified Home Improvement Loans" do not apply to loans for the acquisition of single family homes. None of these requirements applies to Pre-Ullman bonds or qualified veterans' mortgage bonds.

Residence Requirement. The Federal Tax Code requires that each of the premises financed with the lendable proceeds of qualified mortgage bonds be a one-to-four-family residence, one unit of which can reasonably be expected to become the principal residence of the veteran within a reasonable time after the financing is provided. Certain documents adopted by the Department establish procedures to be followed in connection with Contracts of Purchase which finance the acquisition of single family homes in order to assure that interest paid on the qualified mortgage bonds not be included in gross income for Federal income tax purposes under the Federal Tax Code (the "Single Family Program Documents"). Certain documents adopted by the Department establish procedures to be followed in connection with Contracts of Purchase to finance home improvement loans intended to assure that interest paid on the qualified mortgage

bonds is not included in gross income for Federal income tax purposes under the Federal Tax Code (the “Home Improvement Program Documents,” together with the Single Family Program Documents, the “Program Documents”).

First-Time Homebuyer Requirement. The Federal Tax Code requires that, subject to certain exceptions, the lendable proceeds of qualified mortgage bonds be used to provide financing to borrowers who have not had a present ownership interest in their principal residence during the three-year period prior to execution of the mortgage loan. Veterans are excluded from the foregoing requirement but may only receive financing once pursuant to such exception. All financing with respect to targeted area residences and residences on land possessed under certain contract for deed agreements is treated as satisfying the first time homebuyer requirement.

New Mortgage Requirement. The Federal Tax Code requires that, with certain limited exceptions, the lendable proceeds of qualified mortgage bonds finance new mortgage loans only and that no proceeds may be used to acquire or replace an existing mortgage loan, which would include the refinancing of a pre-existing mortgage loan.

Purchase Price Limitation. The Federal Tax Code requires that the purchase price of the residence financed with the lendable proceeds of qualified mortgage bonds may not exceed 90% of the average area purchase price applicable to such residence or 110% of the applicable average area purchase price in the case of residences located in targeted areas.

Income Limitation. The Federal Tax Code requires that all mortgage loans made from the lendable proceeds of qualified mortgage bonds be made only to borrowers whose family income does not exceed 115% (for mortgage loans made to families with fewer than three members, 100%) of the applicable median family income. An exception is provided for mortgage loans financed with the lendable proceeds of qualified mortgage bonds made with respect to targeted area residences that permits two-thirds in aggregate amount of such mortgage loans to be made with respect to borrowers whose family income does not exceed 140% (for mortgage loans made to families with fewer than three members, 120%) of the applicable median family income and one-third in aggregate amount of such loans to be made without regard to any income limitation.

Federal tax law permits higher income limits for persons financing homes located in certain “high housing cost areas.” A high housing cost area is a statistical area for which the ratios of the area’s average purchase price for existing and new single family houses to the area’s median income exceed 120% of the same ratios determined on a national basis. These ratios are determined separately with respect to new and existing single family residences. An area is a high housing cost area only if the ratios for both new and existing houses meet the 120% test. In high housing cost areas, the veteran income limits are increased above 115% (or 100%, as applicable) by one percent for each percentage point (1%) by which the new or existing housing price ratio, whichever is smaller, exceeds 120%. However, the new limit cannot exceed 140% (or 120%, as applicable) of the income limits otherwise applicable. Certain areas of the State may qualify as high housing cost areas.

Family income includes income of all individuals executing both the note and mortgage and occupying the dwelling as their principal residence.

Requirements as to Assumptions. The Federal Tax Code provides that a mortgage loan may be assumed only if each of the then applicable residence requirements,

first-time-homebuyer requirement, purchase price limitation, and income limitation is met with respect to such assumption.

Qualified Home Improvement Loans. The Federal Tax Code requires that a home improvement loan financed with the lendable proceeds of qualified mortgage bonds not exceed \$15,000, be made only with respect to an owner-occupied residence, and finance alterations, repairs, and improvements on or in connection with an existing one-to-four-family residence by the owner thereof, but only if such alterations, repairs and improvements substantially protect or improve the basic livability or energy efficiency of the property.

General. Qualified mortgage bonds treated under the Federal Tax Code as one bond issue for federal tax purposes (“qualified mortgage issue”) are deemed to meet the loan eligibility requirements of the Federal Tax Code if (i) the issuer in good faith attempted to meet all the loan eligibility requirements before the mortgage loans were executed, (ii) any failure to comply with the loan eligibility requirements is corrected within a reasonable period after such failure is first discovered, and (iii) 95% or more of the proceeds of the issue used to make mortgage loans was used to finance residences that met all such requirements at the time the mortgage loans were executed.

Refinancing of Subprime Loans. Among its provisions, the Housing and Economic Recovery Act of 2008 (“HERA”) permits the proceeds of qualified mortgage bonds issued prior to January 1, 2011 to be used to refinance “subprime” loans of qualified borrowers who have an adjustable-rate single-family residential mortgage loan that was made between January 1, 2002 and December 31, 2007. The required unexpended proceeds redemption for any proceeds provided by bonds issued under HERA is changed from 42 months to 12 months, and the purchase price limitation described above under “Purchase Price Limitation” is measured by the market value of the residence at the time of the refinancing, in lieu of the acquisition price. The requirements described above under “First-Time Homebuyer Requirement” and “New Mortgage Requirement” will not apply to such subprime loans. Issuers, such as the Department, are to determine what qualifies as a “subprime” loan, based on a determination of reasonable likelihood of financial hardship to the borrower absent such refinancing. The other qualified mortgage bond requirements described under this heading will apply to such loans.

QVMB Proceeds

The Federal Tax Code requires that each mortgagor to whom financing is provided under a qualified veterans’ mortgage bond issue have served on active duty at some time before January 1, 1977 and apply for financing before the later of January 31, 1985 or the date which is 30 years after the last date on which the veteran left active service. The Department has established and has covenanted to comply with such requirements.

Generally, only the loan eligibility requirements stated above under “QMB Proceeds – Residence Requirement,” “– New Mortgage Requirement” and “– Qualified Home Improvement Loans” (except the \$15,000 maximum loan amount) apply to QVMB Proceeds.

Other Requirements Imposed by the Federal Tax Code

General. The Federal Tax Code provides that gross income for federal income tax purposes does not include interest on a mortgage revenue bond if it is a qualified mortgage bond or a qualified veterans’ mortgage bond. A qualified mortgage bond is a part of an issue of a state or political subdivision all the proceeds of which (net of amounts applied to any costs of issuance

thereof and to fund a reasonably required reserve) are used to finance (or to refund bonds all of such net proceeds of which were used to finance) owner-occupied residences. A qualified veterans' mortgage bond is part of an issue 95 percent or more of the net proceeds of which are used to provide residences to veterans. In addition, in order to be a qualified mortgage bond or a qualified veterans' mortgage bond, a bond must be part of an issue that meets certain (i) general requirements, (ii) arbitrage restrictions on the use and investment of proceeds of the issue, and (iii) loan eligibility requirements set forth in the Federal Tax Code and as more fully described above under "Loan Eligibility Requirements Imposed by the Federal Tax Code."

Volume Limitation, Targeted Area and Required Reports. The first general requirement of the Federal Tax Code, applicable to qualified mortgage bonds, is that the aggregate amount of private activity bonds (exclusive of qualified veterans' mortgage bonds) that may be issued by the Department in any calendar year (or previous years' carried forward amount) must not exceed the portion of the private activity bond volume limit for the State for such calendar year that is allocated by the State to the Department. With respect to qualified veterans' mortgage bonds, a separate limit is based on statutory formulae. The second general requirement of the Federal Tax Code applicable to qualified mortgage bonds is that at least 20% of the lendable proceeds of an issue of bonds which are not refunding bonds (if such set-aside was satisfied with respect to the bonds being refunded) must be made available (and applied with reasonable diligence) for owner-financing of residences in targeted areas (as defined by the Federal Tax Code) for at least one year after the date on which such funds are first available for such owner-financing (the "targeted area requirement"). The third general requirement of the Federal Tax Code requires the issuer of qualified mortgage bonds and qualified veterans' mortgage bonds to file with the Internal Revenue Service reports on the issuance of its qualified mortgage bonds or qualified veterans' mortgage bonds following such issuance, as well as an annual qualified mortgage loan information report.

Yield Limitations and Rebate. The Federal Tax Code requires that the effective interest rate on mortgage loans financed with the lendable proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds may not exceed the yield on the issue by more than 1.125% (1.50% for Pre-Ullman bonds), and that certain investment earnings on non-mortgage investments, calculated based upon the extent such investment earnings exceed the amount that would have been earned on such investments if the investments were invested at a yield equal to the yield on the issue, be rebated to the United States or to veterans. These requirements apply to both Revenue Bonds and Veterans G.O. Bonds, except that for Revenue Bonds, rebate is paid to the United States and that for Veterans G.O. Bonds, rebate, absent an election to pay to the United States, is paid to veterans. See APPENDIX B – "THE DEPARTMENT OF VETERANS AFFAIRS OF THE STATE OF CALIFORNIA, THE PROGRAM AND THE 1943 FUND – THE PROGRAM – Contracts of Purchase" for discussions of provisions of the Veterans Code which affect the Department's ability to establish and to change interest rates on Contracts of Purchase.

Recapture Provision Applicable to Qualified Mortgage Bonds. For certain mortgage loans made after December 31, 1990 from the lendable proceeds of qualified mortgage bonds issued after August 15, 1986 (not including the Offered Veterans G.O. Bonds), and for assumptions of such mortgage loans, the Federal Tax Code requires a payment to the United States from certain borrowers upon sale or other disposition of their homes (the "Recapture Provision"). The Recapture Provision requires that an amount determined to be the subsidy

provided by a qualified mortgage bond financing to a borrower be paid to the United States on disposition of the residence (but not in excess of 50% of the gain realized by the borrower). The recapture amount would (i) increase over the period of ownership, with full recapture occurring if the residence were sold between four and five full years after the closing of the mortgage loan and (ii) decline ratably to zero with respect to sales occurring between five and nine full years after the closing of the mortgage loan. An exception excludes from recapture part or all of the subsidy in the case of certain assisted individuals whose incomes are less than prescribed amounts at the time of the disposition. The Federal Tax Code requires an issuer to inform borrowers of certain information with respect to the Recapture Provision.

Required Redemptions. For qualified mortgage bonds issued after 1988, the Federal Tax Code requires redemption of certain qualified mortgage bonds issued after 1988 from unexpended proceeds required to be used to make mortgage loans that have not been used within 42 months (except it shall be 12 months with respect to the proceeds of qualified mortgage bonds issued using the additional private activity bond volume allocation authorized by HERA, including as described above under “Loan Eligibility Requirements Imposed by the Code — Refinancing of Subprime Loans”) from the date of issuance (or the date of issuance of the original bonds in the case of refundings of unexpended proceeds), except for a \$250,000 *de minimis* amount. As a result, the redemption of Revenue Bonds that are qualified mortgage bonds from proceeds attributable to such Revenue Bonds not used to make Mortgage Loans may be required. Additionally, for bonds issued after 1988, the Federal Tax Code permits repayments (including prepayments) of principal of mortgage loans financed with the proceeds of an issue of such bonds to be used to make additional mortgage loans for only 10 years from the date of issuance of the bonds (or the date of issuance of the original bonds in the case of refundings), after which date such amounts must be used to redeem bonds, except for a \$250,000 *de minimis* amount. As a result, the Department is required by the Federal Tax Code to redeem Revenue Bonds which are qualified mortgage bonds from repayments (including prepayments) of principal of certain Contracts of Purchase not later than the close of the semi-annual period after the payment is received.

Compliance. The Federal Tax Code states that an issuer will be treated as meeting the targeted area requirement, the arbitrage restrictions on mortgage loans, and the recapture information requirements if it in good faith attempted to meet all such requirements and any failure to meet such requirements was due to inadvertent error after taking all reasonable steps to comply with such requirements.

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APPENDIX F
PROPOSED FORM OF LEGAL OPINION OF ATTORNEY GENERAL

[Closing Date]

The Honorable Bill Lockyer
State Treasurer
Sacramento, California

\$118,710,000		
STATE OF CALIFORNIA		
VETERANS GENERAL OBLIGATION BONDS		
\$82,725,000	\$25,000,000	\$10,985,000
Series CF (Non-AMT)	Series CG (Non-AMT)	Series CH (AMT)

Final Opinion

Honorable Bill Lockyer:

We have acted as counsel to the State of California (the “State”) in connection with the issuance by the State of \$118,710,000 aggregate principal amount of State of California Veterans General Obligation Bonds dated June 29, 2010 issued as three separate series under five bond acts, all identified in Schedule A hereto, which is incorporated by reference (collectively, the “Bonds”). The Bonds are authorized pursuant to (i) the respective veterans bond acts identified in Schedule A (collectively, the “Bond Acts”), (ii) Part 3 of Division 4 of Title 2 of the California Government Code and (iii) resolutions adopted by the Veterans’ Finance Committee of 1943, identified in Schedule B hereto, which is incorporated by reference (the “Resolutions”).

In such connection, we have examined the record of proceedings submitted to us relative to the issuance of the Bonds, including the Resolutions, certifications of the State, and such other documents and matters deemed necessary by us to render the opinions set forth herein, although in doing so, we have not undertaken to verify independently, and have assumed, the accuracy of the factual matters represented, warranted or certified therein. We have assumed the genuineness of all documents and signatures presented to us, the conformity to original documents and certificates of all documents and certificates submitted to us as copies and the authenticity of the originals of all such documents and certificates. Furthermore, we have assumed compliance with the agreements and covenants contained in the Resolutions.

The opinions expressed herein are based upon an analysis of existing laws, regulations, rulings and court decisions and cover certain matters not directly addressed by such authorities. Such opinions may be affected by actions taken or omitted or events occurring after the date hereof.

We have neither undertaken to determine, nor to inform any person, whether any such actions are taken or omitted or events do occur or whether any other matters come to our attention after the date hereof, and we disclaim any obligation to update this letter.

We call attention to the fact that the rights and obligations under the Bonds and the Resolutions and their enforceability may be subject to bankruptcy, insolvency, reorganization, arrangement, fraudulent conveyance, moratorium and other laws relating to or affecting creditors' rights, to the application of equitable principles, to the exercise of judicial discretion in appropriate cases, and to the limitations contained in State law regarding legal remedies against the State. We express no opinion as to whether interest on the Bonds is excluded from gross income for federal income tax purposes or exempt from State of California personal income taxes or as to any other tax consequences related to the ownership or disposition of, or the accrual or receipt of interest on, the Bonds. Finally, we undertake no responsibility for the accuracy, completeness or fairness of the Official Statement dated June 23, 2010, or other offering material relating to the Bonds and express no opinion with respect thereto.

Based on and subject to the foregoing, and in reliance thereon, as of the date hereof, we are of the opinion that the State has lawful authority for the issuance of the Bonds, and the Bonds constitute the valid and binding general obligations of the State payable in accordance with the Bond Acts from the General Fund of the State. The full faith and credit of the State of California is pledged to the punctual payment of the principal of and interest on the Bonds, as the principal and interest become due and payable.

Sincerely,

Deputy Attorney General

For EDMUND G. BROWN JR.
Attorney General of the State of California

SCHEDULE A

\$82,725,000 Series CF

1. \$56,325,000 principal amount of State of California Veterans General Obligation Bonds, Series CF, authorized under the Veterans Bond Act of 1986.
2. \$11,900,000 principal amount of State of California Veterans General Obligation Bonds, Series CF, authorized under the Veterans Bond Act of 1988.
3. \$14,500,000 principal amount of State of California Veterans General Obligation Bonds, Series CF, authorized under the Veterans Bond Act of 1996.

\$25,000,000 Series CG

\$25,000,000 principal amount of State of California Veterans General Obligation Bonds, Series CG, authorized under the Veterans Bond Act of 2000.

\$10,985,000 Series CH

1. \$3,220,000 principal amount of State of California Veterans General Obligation Bonds, Series CH, authorized under the Veterans Bond Act of 1986.
2. \$7,700,000 principal amount of State of California Veterans General Obligation Bonds, Series CH, authorized under the Veterans Bond Act of 1988.
3. \$65,000 principal amount of State of California Veterans General Obligation Bonds, Series CH, authorized under the Veterans Bond Act of 1990.

SCHEDULE B

<u>Bond Act</u>	<u>Resolution Number</u>	<u>Date of Adoption by Veterans Finance Committee Resolution</u>
Veterans Bond Act of 1986	XIX	March 18, 2009
Veterans Bond Act of 1988	XII	March 18, 2009
Veterans Bond Act of 1990	XII	March 18, 2009
Veterans Bond Act of 1996	VII	March 18, 2009
Veterans Bond Act of 2000	II	January 18, 2006

APPENDIX G
PROPOSED FORM OF LEGAL OPINION OF BOND COUNSEL TO THE STATE

[Closing Date]

The Honorable Bill Lockyer
State Treasurer
Sacramento, California

Ladies and Gentlemen:

We have acted as bond counsel to the State of California (the “State”), and in such capacity we have examined upon request copies of proceedings taken by the State in connection with the issuance of the State’s \$82,725,000 aggregate principal amount Veterans General Obligation Bonds, Series CF (the “Series CF Bonds”), \$25,000,000 aggregate principal amount Veterans General Obligation Bonds, Series CG (the “Series CG Bonds”) and \$10,985,000 aggregate principal amount Veterans General Obligation Bonds, Series CH (the “Series CH Bonds,” and together with the Series CF Bonds and the Series CG Bonds, the “Bonds”) and the sale of the Bonds to the initial purchasers thereof. The Bonds are issued pursuant to (i) the Veterans Bond Acts identified in Schedule A hereto (collectively the “Law”), which is incorporated by reference, each of which was approved by the electors of the State, (ii) Part 3 of Division 4 of Title 2 of the California Government Code, and (iii) resolutions (the “Resolutions”) adopted by the Veterans’ Finance Committee of 1943, and identified in Schedule B hereto, which is incorporated by reference.

The Bonds are dated, mature on the dates in the principal amounts, bear interest, if any, and are payable as provided in the Resolutions. The Bonds are subject to redemption prior to maturity in whole or in part as provided in the Resolutions.

Applicable federal tax law establishes certain requirements that must be met subsequent to the issuance of the Bonds in order that interest on the Bonds not be included in gross income for Federal income tax purposes under the Internal Revenue Code of 1986, as amended (the “Code”). The Department of Veterans Affairs of the State of California (the “Department”) has adopted documents with respect to its program (the “Program Documents”) that establish procedures under which, if followed, such requirements can be met. The State and the Department have covenanted in the Resolutions and in tax certificates and other documents applicable to the issuance of the Bonds (collectively with the Program Documents, the “Documents”), to at all times perform all acts and things permitted by law and necessary and desirable in order to assure that interest paid on the Bonds shall not be included in gross income for federal income tax purposes under the Code. In rendering this opinion, we have relied upon such covenants and have assumed compliance by the State and the Department with the provisions of such Documents.

In connection with the issuance of the Bonds, we have examined (a) a copy of the Resolutions, and (b) such other opinions, documents, certificates and letters as we deem relevant and necessary in rendering this opinion.

From such examination, we are of the opinion that:

(1) The State has lawful authority for the issuance of the Bonds, and the Bonds constitute valid and binding general obligations of the State payable in accordance with the Law from the General Fund of the State. The full faith and credit of the State of California is pledged to the punctual payment of the principal of and interest on the Bonds as the principal and interest become due and payable.

(2) Under existing statutes and court decisions and assuming compliance with certain tax covenants described herein, interest on the Bonds is not included in gross income for Federal income tax purposes pursuant to Section 103 of the Code and (i) interest on the Series CF Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code; such interest, however, is included in the adjusted current earnings of certain corporations for purposes of calculating the alternative minimum tax imposed on such corporations; (ii) interest on the Series CG Bonds is not treated as a preference item in calculating the alternative minimum tax imposed on individuals and corporations under the Code and is not included in the adjusted current earnings of corporations for purposes of calculating the alternative minimum tax; and (iii) interest on the Series CH Bonds is treated as a preference item for purposes of calculating the alternative minimum tax imposed on individuals and corporations under the Code.

(3) Interest on the Bonds is exempt from State personal income taxation under present State law.

We express no opinion regarding any other Federal or state tax consequences with respect to the Bonds. We render our opinion under existing statutes and court decisions as of the issue date, and assume no obligation to update our opinion after the issue date to reflect any future action, fact or circumstance, or change in law or interpretation, or otherwise. We express no opinion on the effect of any action hereafter taken or not taken in reliance upon an opinion of other counsel on the exclusion from gross income for Federal income tax purposes of interest on the Bonds, or under state and local tax law. We undertake no responsibility for the accuracy, completeness or fairness of any official statement or other offering materials relating to the Bonds and express herein no opinion relating thereto.

In rendering this opinion, we are advising you that the enforceability of the Bonds may be limited by bankruptcy, moratorium, insolvency, or other laws affecting creditors' rights or remedies and is subject to general principles of equity (regardless of whether such enforceability is considered in a proceeding in equity or at law).

Very truly yours,

SCHEDULE A

\$82,725,000 Series CF

1. \$56,325,000 principal amount of State of California Veterans General Obligation Bonds, Series CF, authorized under the Veterans Bond Act of 1986.
2. \$11,900,000 principal amount of State of California Veterans General Obligation Bonds, Series CF, authorized under the Veterans Bond Act of 1988.
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\$25,000,000 Series CG

\$25,000,000 principal amount of State of California Veterans General Obligation Bonds, Series CG, authorized under the Veterans Bond Act of 2000.

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1. \$3,220,000 principal amount of State of California Veterans General Obligation Bonds, Series CH, authorized under the Veterans Bond Act of 1986.
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3. \$65,000 principal amount of State of California Veterans General Obligation Bonds, Series CH, authorized under the Veterans Bond Act of 1990.

SCHEDULE B

<u>Bond Act</u>	<u>Resolution Number</u>	<u>Date of Adoption by Veterans Finance Committee Resolution</u>
Veterans Bond Act of 1986	XIX	March 18, 2009
Veterans Bond Act of 1988	XII	March 18, 2009
Veterans Bond Act of 1990	XII	March 18, 2009
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Veterans Bond Act of 2000	II	January 18, 2006

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